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4000 Financial Analysis

The analysis of financial factors should be conducted in four primary parts, namely: (1) parent only, (2) banking subsidiary(ies), (3) nonbank subsidiary(ies), and (4) consolidated organization. In view of the fact that all BHCs are not structured in the same organizational and financial manner, it is important that examiners be flexible in their approach and be judicious in their use of ratio analysis and peer group comparisons. There is no substitute for using sound judgment and creativity while performing an analysis, providing all of the pertinent information is available. The summary and conclusions should follow from the information presented in the analysis.

The analysis is intended to determine the financial strengths and weaknesses of an organization and the impact of conditions at the parent company and nonbank subsidiary which could adversely affect the condition of the banking subsidiary. As a regulatory agency, a goal of the Federal Reserve System is to safeguard and protect the soundness of commercial banks. The System oversees holding company banking and nonbanking activities to assure the continued safety and soundness of individual banks and the industry as a whole.

The analysis of financial factors resulting from the inspection of a bank holding company is essentially a finding of facts and an expression of judgment. In conducting an appraisal of a holding company's condition, the financial analysis of the organization, based on a ''building block'' or ''component'' approach, should provide the examiner with a solid foundation from which to proceed. In order to complete the analysis it is first necessary to accumulate sufficient information concerning the parent company, bank and nonbanking subsidiary(ies) and the consolidated organization. A final analysis should not be attempted until these integral parts have been thoroughly reviewed.

The completion of the financial analysis will culminate with the preparation of a rating for the bank holding company. Manual section 4070.0, entitled ''Bank Holding Company Rating System,'' presents the rating system in its entirety.

4010.0.1 INTRODUCTION AND SCOPE OF THE ANALYSIS

The cash flow analysis is *applicable to all bank holding companies with consolidated assets in excess of $1 billion, those that have substantive fixed charges or debt outstanding,* as well as select others at the option of the Reserve Bank. Key parts of the analysis involve the use of:

1. A standardized ''Cash Flow Statement (Parent)'' page (refer to manual sections 5010.23 and 5020.13 for the illustrated pages) which includes computation of the cash earnings coverage ratios and analyses; regarding the results;

2. Earnings cash flow coverage ratios to measure the parent company's ability:

   a. To pay its fixed charges, including interest costs, lease expense, income taxes, retirement of long-term debt (including sinking fund provisions), and preferred stock cash dividends, and

   b. To pay common stock cash dividends.

3. Guidelines for supervisory determination of parent company debt servicing capacity.

The cash flow statement page of the inspection report presents the cash earnings and the cash expenditures of the parent company. Within the statement are the key components to be used in the ''Fixed Charge Coverage Ratio,'' which measures the parent company's ability to meet its fixed obligations, and a ''Common Stock Cash Dividend Coverage Ratio'' which measures the ability of the remaining, or residual, earnings to cover common stock dividends.

4010.0.2 CASH FLOW STATEMENT

The cash flow statement is an effective tool used in understanding how a particular bank holding company operates. Its primary objective is to summarize the financing and investing activities of the holding company, including the extent to which the entity has generated funds (externally and internally) during the period. The cash flow statement is related to both the income statement and the balance sheet and provides information that otherwise can be obtained only partially by interpreting each of those statements.

An analysis of past cash flow statements can supply important information regarding the uses of funds, such as internal asset growth or acquisitions, as well as data on the sources of funds used and the financing needs of management. A projected cash flow statement will focus on the need for future funds, its applications, and the sources from which they are likely to be available.

Specifically, the analysis of the cash flow statement is necessary for a thorough understanding of a bank holding company and the nature of its operations to the extent that it provides information on such areas as:

1. Utilization of funds provided by operations;
2. Use of funds from a new debt issue or sale of stock;
3. Source of funds used for acquisitions or additional capital contributions;
4. Means of payment of a dividend in the face of an operating loss;
5. Means of debt repayment and stock redemption.

While the cash flow statement provides an overall perspective of a holding company's utilization of available funds, it does not, by itself, indicate possible or actual difficulties the parent company may have in meeting its fixed obligations from internally generated funds. Fixed obligations or fixed charges are those recurring expenses which must be paid as they fall due, which includes interest expense, lease expense, sinking fund requirements, scheduled debt repayments and preferred dividends.

One ratio that may be used to calculate the strength of a parent company's earnings to meet its fixed charges or obligations is the *Fixed Charge Coverage Ratio* (FCCR). The components of the ratio are included on the ''Cash Flow Statement (Parent)'' page. The Fixed Charge Coverage Ratio (FCCR) measures the parent company's ability to pay for *fixed* contractual obligations if management is to *retain control of the organization,* thereby satisfying the expectation of creditors and preferred stockholders. Net income *after taxes* is used in the formula. Interest and lease expenses are already deducted to arrive at the net income figure and must be added back to obtain the earnings available to pay such charges. Interest expense is usually the largest component among all ''fixed charges,'' and the ability to pay this expense from earnings cash flow is critical to an assurance of continued refunding of the parent company's debt. It measures not only the extent to which net cash operating earnings covers the debt servicing requirements of the parent company, but the capacity to pay income taxes and preferred stock

cash dividends as well, thereby meeting the expectations that creditors and preferred shareholders have for the protection of their respective interests. The need for *better than a 1:1* coverage is therefore critical.

Another important formula, required to be calculated is the *Common Stock Cash Dividend Coverage Ratio* (CSCDCR) which measures the ability of the parent company to pay common stock cash dividends. The CSCDCR will show, in turn, whether the residual cash earnings of the parent company are sufficient to pay the common stock cash dividend and, if not, the amount that must be provided from other sources of cash, such as the liquidation of assets or additional borrowings, to cover the shortfall.

Significant shortfalls in the CSCDCR are to be scrutinized in light of the Board's November 1985 Policy Statement on ''Cash Dividends Not Fully Covered by Earnings.'' According to the statement, a bank holding company should not maintain its existing rate of cash dividends on common stock unless:

1. The holding company's net income available to common stockholders over the past year has been sufficient to fully fund the dividends; *and*

2. The prospective rate of earnings retention appears consistent with the organization's capital needs, asset quality, and overall financial condition.

A bank holding company whose cash dividends are inconsistent with the above criteria is to give serious consideration to cutting or eliminating its dividends. The need for *at least a 1:1 coverage* is therefore critical.

The two ratios[1] are calculated as follows:

$$\text{FCCR} = \frac{\text{After tax cash income (1) + interest expense (2) + lease \& rental expense (3)}}{\text{interest expense (2) + lease \& rental expense (3) + contractual long-term debt retired (4) + preferred stock dividend payments (5)}}$$

$$\text{CSCDCR} = \frac{\text{After tax cash income (1) – [Contractual long-term debt retired (4) + preferred stock dividend payments (5)]}}{\text{Common Stock Dividend Payments (6)}}$$

Note that the Cash Flow Statement (Parent) page presents only cash items included in the parent's income and therefore the analyst can use its income figures without any need to adjust for noncash items.

Both the Fixed Charge Coverage and the Common Stock Cash Dividends Coverage ratios are considered inadequate at less than 1:1. If a holding company is generating funds which provide at least dollar-for-dollar coverage, no criticism need be made. However, the examiner should be aware that these ratios, as well as others, are merely guidelines and good judgment must prevail. A ratio of 1.02:1 may pass the test, but it is only barely adequate. No criticism may necessarily be warranted for the period covered by the 1.02:1 ratio, but it may be indicative of a deteriorating trend over the past few years. Accordingly, an appropriate comment concerning the trend may be warranted.

When reviewing these ratios, it should be kept in mind that certain components in the numerator can to some degree be altered at the discretion of management. For example, by altering the dividends paid by bank subsidiaries, the amount of funds available to the parent to cover fixed charges can be increased or decreased. For this reason, the fixed charge and funds flow ratios should be analyzed in conjunction with a review of the dividend payout ratios of the subsidiary banks. Cash flow ratios that otherwise appear adequate may be a cause for concern if the banks are paying out dividends that are too high in relation to capital or overall condition. Analysts should evaluate the bank dividend payout ratios in light of the bank's capital and financial condition. Only in this way can the analyst gain a better understanding of the quality of the parent's cash flow and its potential effect on bank subsidiaries.

Ratios of less than 1:1 coverage show that internally generated funds are not sufficient to meet a parent company's needs. In many cases, the examiner may find low coverage ratios yet all fixed charges were paid as agreed. Had they not been, the company would have incurred severe financial difficulties long before the start of the inspection. Therefore, when less than adequate ratios appear and obligations are paid

1. The numbered ( ) items correspond to the numbered lines on the ''Cash Flow Statement (Parent)'' page.

on time, the examiner must determine what other source of funds was utilized to make up the shortfall and to permit the timely payment of obligations.

4010.0.3 SUPERVISORY DETERMINATION AS TO ADEQUACY OF PARENT COMPANY CASH FLOW

A supervisory determination about the adequacy of parent company cash flow, and its use as a measure of parent company debt servicing capacity, requires more information than just the results of the Fixed Charge Coverage and Common Stock Cash Dividend Coverage Ratios. The typical major parent company does not generate an earnings cash flow by conducting banking operations itself, although it nevertheless may incur a heavy external debt on behalf of its operating subsidiaries which are the generators of the actual earnings cash flow. Therefore, the parent company earnings cash flow may not be indicative of the *actual* earnings power of the entire banking organization. For example, the cash earnings of the parent company may be kept low by management to avoid State or local income tax liability and/or to increase leveraged lending volumes at the subsidiary level. Conversely, cash earnings may be forced to the parent company through imprudent levels of upstream cash dividend payments which eventually will endanger the operating subsidiaries and the parent itself.

A supervisory determination about the adequacy of parent company cash flow must take place at *two levels:* (1) by analyzing the results of the two coverage ratios using the net earnings cash flow *realized* by the parent company, *and* (2) by analyzing the effect that upstream cash flow to the parent company has had, and can be expected to have, on the financial condition of the bank subsidiaries and the significant nonbank subsidiaries. The latter focus should be on significant nonbank subsidiaries whose capital and dividend policies are subject to separate regulation—such as thrifts—or subsidiaries with significant external funding, whose creditors presumably monitor capital and dividend policies of the subsidiary.

4010.0.4 SPECIFIC GUIDELINES FOR DEBT SERVICING CAPACITY

The specific guidelines for debt servicing capacity are as follows:

1. The adequacy or inadequacy of parent company cash flow, and thereby the capacity to sustain the parent company's debt, is determined ultimately from the results of the Fixed Charge and Common Stock Cash Dividend Coverage Ratios, and the related analysis of the effects of upstream cash flow on the financial condition of the key subsidiaries.

2. For those parent companies with material amounts of long-term debt, coverage ratios in excess of 1:1 will not necessarily be considered sufficient to sustain the parent company's leverage *unless: first,* the Tier 1 capital positions of the bank subsidiaries are considered adequate; *second,* that the bank holding company's consolidated Tier 1 capital position is considered adequate; and *third,* the parent's liquidity is judged adequate. If that is not the case, then a critical comment on the ''Examiner's Comments'' page should be made regarding the potentially excessive leverage of the parent, as well as that of its subsidiaries. A specific period of time should be established for the management of the bank holding company to submit a capital improvement program acceptable to the System. *Moreover,* where the capital positions, bank and consolidated, are considered adequate but the dividend payout ratios are excessive, it is indicative of a potential future debt servicing problem and should be brought to management's attention. Since the earnings level may not be sustainable, corrective action must be taken within a specified period of time.

3. For coverage ratios of less than 1:1, there is a presumption of a critical comment on the ''Examiner's Comments'' page of the inspection report *unless* the shortfall is prudently planned,[2] insignificant in amount and/or the trend of earnings cash flow and dividend policies clearly point toward a return to sufficient parent company earnings cash flow coverage.

a. In circumstances where the Tier 1 capital position of *any bank subsidiary* is considered inadequate, a written program of corrective action should be required, including the steps necessary to reestablish positive earnings cash flow coverage at the parent company.

b. In circumstances where the Tier 1 *consolidated* capital position of the holding company is considered inadequate, a written pro-

2. A planned cash flow shortfall might typically occur when the parent elects to reduce (or not increase) dividends from subsidiaries because it anticipated an excess cash or liquid asset position from certain *external sources* (i.e., stock or debt issuance, dividend reinvestment plans, or tax refunds) sufficient to cover the deficiency.

gram of corrective action should be required, including the steps necessary to reestablish positive earnings cash flow coverage at the parent company.

c. In circumstances where the Tier 1 capital position of *each bank subsidiary* and the consolidated Tier 1 capital position of the bank holding company is considered adequate, but there is a developed trend of inadequate earnings cash flow coverage at the parent company level or excessive dividend payouts from the subsidiaries, a written program of corrective action should be required to reestablish and maintain a positive earnings cash flow at the parent company.

4010.0.5 SOURCES OF FUNDS TO MAKE UP SHORTFALLS

Basically, there are three source categories, other than current earnings, that could be used to make up any deficit: (1) liquidation of assets, (2) proceeds from a stock offering, or (3) borrowed funds. These sources must be thoroughly analyzed to determine the extent they were and could still be utilized. It must be kept in mind that the use of these sources cannot permanently eliminate a shortfall in the flow of funds from current operations. These alternative sources only alleviate temporarily the effects of a shortfall. Nevertheless, a deficit could have been intentionally allowed to occur because the holding company knew of funds coming from these alternate sources. For example, the parent knew of an impending stock sale and cut dividends from subsidiaries significantly. In future years, dividends from subsidiaries could be restored to normal proportions, bringing the ratios up to adequate levels.

At this point, it must be determined what, if any, criticism is necessary when an unplanned shortfall is made up by any of these alternate sources. The necessity of liquidating assets to meet cash needs may warrant a critical comment. The parent's advances to subsidiaries and its investment in marketable securities are considered temporary investments. That is, the holding company may reasonably expect to sell its securities and be repaid on its advances to subsidiaries within a reasonably short period of time. In the case of advances to a problem subsidiary, repayments may not be forthcoming. Nevertheless, if the parent does receive partial payments, such funds are available to meet cash needs. The concern to the examiner is the extent to which such temporary investments can be relied upon before they are fully exhausted. If the continued liquidation of those investments to meet cash needs has fully exhausted the assets or will do so in the near future, then appropriate critical comments are warranted. Such comments should stress that the liquidation of the investment portfolio and the advances to subsidiaries can no longer be considered a reliable source of funds.

Another method which may be used by a holding company to overcome a flow of funds deficiency is the sale of capital stock which is an effective source for generating permanent funds for the parent. However, it must be recognized that the primary reason for the stock offering was something other than covering the shortfall (i.e., debt repayment, capital contributions to subsidiaries, acquisitions). Therefore, it cannot be relied upon as a consistent annual source to supplement internally generated funds from operations. Also, it should be realized that the sale of stock will increase future funding requirements as additional dividends will have to be paid. Consequently, where no significant improvement in internal operations is contemplated in future periods, an appropriate comment is warranted indicating the potential problem.

Holding companies also compensate for inadequate funds flow with borrowed money. Although not a permanent source of funds, long-term debt is a source similar to the sale of stock. Its main purpose, however, was not to cover the shortfall. Long-term debt cannot be considered as a reliable, consistent annual source, and moreover, its existence creates new funding requirements.

Short-term debt is perhaps the most commonly used source to cover a deficit cash flow from operations and its use is of serious concern from a supervisory viewpoint. Unlike long-term debt and equity issues, short-term borrowings (i.e., bank loans, commercial paper) are readily available to holding companies which can and do rely on this source year after year for support. As a consequence, this indebtedness increases fixed charges and where material improvement in earnings does not develop, the shortfall could increase in subsequent periods thereby necessitating even larger borrowing requirements. This practice may jeopardize the parent's liquidity position since short-term liabilities rise without a corresponding increase in liquid assets as the borrowed funds are used to pay expenses. Here, an appropriate comment is warranted indicating the problems.

4010.0.6 REPORTING THE RESULTS

If the coverage ratios are less than 1:1, then appropriate comments are necessary to explain the external source utilized to make up the shortfall. The supporting details may be shown within the comments section of the Cash Flow Statement. More significant comments should be included on the ''Analysis of Financial Factors'' page or the ''Examiner's Comments'' page. The examiner may include prior years' results for comparative purposes.

4010.0.7 INSPECTION OBJECTIVES

1. To determine the ability of the parent to manage its cash position and operate within debt service and funding requirements.
2. To measure the parent's ability to meet its fixed obligations and its dependency on borrowed funds to meet its cash needs.
3. To determine if the parent company's dividends to stockholders are covered by residual cash earnings.
4. To analyze any cash flow transaction which may adversely affect the financial stability of the parent.
5. To discuss with parent company management:

a. Deficit cash flows arising from internal operations;

b. Steps management has taken, or plans to take, to restore adequate cash earnings coverage for fixed charges and dividend payments and whether such plans should be commensurate with the maintenance of adequate loan loss reserves and Tier 1 capital levels in the bank and major nonbank subsidiaries.

c. Any parent company borrowings or restructurings needed to sustain dividend payments to shareholders; and

d. The need to increase cash flow although there may be no deficit in current cash flow coverage.

4010.0.8 INSPECTION PROCEDURES

1. Prepare the ''Cash Flow Statement (Parent)'' FR 1225.

a. Analyze each item of the parent company's comparative balance sheet and income statement. Since accrual figures may be used for all accounts except tax and dividend payments, adjustment to the figures may be necessary for the difference between accrual and cash basis accounting.

b. Examine the underlying nature of period increases or decreases for the balances listed on the financial statements, particularly any material transactions that aided in averting coverage ratio shortfalls.

c. Note contractual long-term debt retired (net decrease in borrowed funds, including sinking fund provisions) as a memo item on the bottom of the page, where indicated.

d. Compute the fixed charge and common stock cash dividend coverage ratios as illustrated on the page. *The numbered items in the formula correspond with the numbered items on the ''Cash Flow Statement (Parent)'' page.*

e. Answer the six questions on the ''Cash Flow Statement (Parent)'' page that prompt an analysis.

2. Analyze the Results.

a. If there is full coverage, no problem should be assumed. However, *the underlying assets and transactions that provided for the coverage should be examined to make certain that ''no problem'' does, in fact, exist.*

b. If a shortfall exists, provide guidelines to the parent company's management for developing a workable contingency plan, using your ''good examiner judgement'', considering the viability of all sources in resolving the shortfall.

- Review the *sources* for making up shortfalls:
  - — Liquidation or sale of assets, *giving full consideration to external market concerns and losses that may result from the sales.*
  - — Proceeds from stock offerings.
  - — Increase in borrowed funds, including a restructuring of short term debt to long term debt.
  - — Sale of capital stock.
  - — Payments from subsidiaries on advances in the form of amortization or interest.
  - — Short term debt.

3. Report the Results.

a. *When an ''engineered'' (planned) shortfall exists,* indicate that one does exist, the reasons therefore, and the degree of severity to which it should be addressed, either as part of the answers to the questions on the ''Cash Flow Statement (Parent)'', the ''Analysis of Financial Factors'' page, or the ''Examiner's Comments'' page. Provide management's assessment as to

whether planned short falls will occur in the future.

b. When an *unplanned shortfall exists*, determine the extent of criticism that is to be made when short falls are lessened or corrected by an imprudent use of *alternative sources.* Based on the severity of the situation, determine whether the comments will be provided in the inspection report as answers to the questions on the Cash Flow Statement, or within the content of the ''Analysis of Financial Factors'' page, or the ''Examiner's Comments'' page.

BHC financial leverage is the use of debt to supplement the equity in a company's capital structure. It is anticipated that funds generated through borrowings will be invested and earn a rate of return above their cost so that the net interest margin generated will improve the company's net income, providing a higher rate of return on stockholders' equity which has otherwise remained constant. Since no creditor or lender would be willing to extend credit without the cushion and safety provided by the stockholders' equity, this borrowing process is also referred to as ''trading on equity.'' That is, utilizing the existence of a given amount of equity capital as a borrowing base. Stockholders and management often view leveraging as a favorable financial alternative because if owners have provided only a small portion of total financing, much of the financial risk will be borne by the lenders, alleviating the need of the stockholders to assume the total risk. In addition, by raising funds through long-term debt, the owners gain the benefits of maintaining control of the firm with a limited investment rather than diluting existing ownership via the sale of additional capital stock.

There are, however, some unfavorable aspects in this type of financing. As a holding company substitutes debt for equity, keeping its asset size constant, its leverage ratio will increase. The increase in leverage increases the probability that a company may go into default since a larger portion of the income stream generated by earning assets must then be used to meet increased fixed charges (interest expense). (This assumes that increases in future earnings are not anticipated. While earnings may be sufficient to meet fixed interest expenses at the time the debt is issued, it is possible that future earnings will not be sufficient to meet the increased expenses.) In addition, utilization of leverage reduces management flexibility in making future decisions because lenders impose restrictive covenants that may limit future debt issues, limit dividend payments, or impose constraints on specific operating ratios. However, not all of the effects of increased leverage are unfavorable. Additional long-term debt may have the favorable effect of extending maturities on obligations and may improve liquidity.

Leverage ratios measure the contribution of owners compared with the financing provided by lenders. Companies with low leverage ratios generally have less exposure to loss when the economy is in a recession, but they may also have lower expected returns when the economy booms. Firms with high leverage ratios run the risk of large losses but also have a chance of earning high rates of return on equity and assets. Thus, if a company earns more on the borrowed funds than it pays in interest, the return to the owners is increased. For example, if the company earns 10 percent on assets and debt costs 8 percent, there is a 2 percent differential accruing to the stockholders. However, if the return on assets falls to 7 percent, the differential between that figure and the cost of debt must be made up from total profits.

A bank holding company is composed of at least two tiers, parent and subsidiary, and each tier may issue long-term debt in its own name. Several different types of long-term debt instruments are utilized by holding companies. Corporations make use of instruments such as debentures, convertible debentures, term loans, capital notes and mortgage notes. (See Manual section 2080.0—''Funding''). While most issues are generally sold to the public, in some cases, issues of subsidiaries have been placed directly with another subsidiary, the parent company, or perhaps with an unaffiliated banking institution. Alternatively, issues presently held on the books of the parent may have been originally issued by one of the subsidiaries and later transferred to the parent. These transfers have often occurred at the time of the formation of the holding company when debt of the subsidiaries was assumed by the parent.

The proceeds of parent company long-term debt may be advanced to banking subsidiaries as debt or invested in banking subsidiaries as equity. When parent debt is issued, and the proceeds are advanced to subsidiaries as debt, a condition of ''***simple leverage***'' exists. When such proceeds are invested in subsidiaries as equity, a condition of ''***double leverage***'' is said to exist since the increase in the subsidiary bank's capital base will allow the bank to increase its own borrowings.[1] In effect, the

1. Parent company ''***total leverage***'' may be defined as the relationship between equity at the parent level and the total assets of the parent company. Such assets typically consist of investments in bank and nonbank subsidiaries, advances to affiliates, deposits with bank affiliates and securities. A useful related measure of parent company leverage is ''***investment leverage***'' which may be defined as the relationship between parent equity and its equity investments in subsidiaries. Since the equity which has been invested in subsidiaries can, and often is, further leveraged by external borrowings of such subsidiaries, this type of parent company investment leverage can lead to what is referred to as ''***double leverage***.''

parent's capital injection which was funded by debt, provides the bank with greater debt capacity, thereby allowing the bank to borrow additional funds on its own. Therefore, the original borrowing by the parent has, in effect, been compounded when the bank borrows based on its newly injected equity.

If the parent debt is reinvested as equity in a bank, the servicing of interest and principal is usually provided by dividends paid to the parent by the bank subsidiaries. The bank dividends, however, may become restricted based on the bank's earning power which may not provide for sufficient retention of earnings to support its asset growth. Problems may be less severe when parent debt is downstreamed as debt to the bank subsidiary. When the terms and maturities of the indentures match, the obligation of a bank to meet its interest and principal payments to the parent are contractual and represent fixed charges (interest is tax deductible) which will continue up to the maturity of the note. When funds are downstreamed as equity and the bank typically issues dividends to its parent, it is easier to restrict the flow of funds from the bank than if the funds were downstreamed as debt which results in bank payments of interest expense. Bank dividend declarations are subject to limitations imposed by sections 5199(b) (12 U.S.C. 60) and 5204 (12 U.S.C. 56) of the United States Revised Statutes, while interest payments are not subject to such restrictions.

4010.1.1 ACQUISITION DEBT

Some holding companies use debt for the acquisition of subsidiary banks. The Board believes that a high level of acquisition debt can impair the holding company's ability to act as a source of strength to its bank subsidiaries, and thus does not favor the use of a substantial amount of acquisition debt in bank holding company formations. However, the Board recognizes that the use of acquisition debt in the formation of certain holding companies may be necessary, particularly when transferring the ownership of small community banks (approximately $150 million or less), and the maintenance of local ownership in those banks. To this end, and in the interest of maintaining a safe and sound banking system, the Board has adopted a policy for assessing financial factors in the formation of small one-bank holding companies. (see Manual section 2090.2)

4010.1.2 INSPECTION CONSIDERATIONS

Generally, it is not the examiner's responsibility to criticize the method of term financing used by a bank holding company. The examiner, however, should be familiar with the various types of leveraging and the possible ramifications that they may have on a holding company structure. While the use of ratios may show an excessive leverage position, indicating vulnerability, it is primarily the corporation's earning power that dictates the acceptable level of debt. Accordingly, the examiner should compute a holding company's ability to meet its fixed charges (as detailed in the preceding section) to determine the appropriateness of the leverage position. If the company's earnings do not support the present fixed charge requirements, or if a declining trend is noted, appropriate comments are warranted.

4010.2.1 INTRODUCTION

Liquidity is generally defined as the ability of a company to meet its short-term obligations, to convert assets into cash or to obtain cash, or to roll-over or issue new short-term debt. Short-term is generally viewed as a time span up to a year. Since a bank holding company does not have the full range of asset and liability management options available to it that a bank does in managing its liquidity position, it therefore, needs to have a sufficient cushion of liquid assets to support maturing liabilities. Certain assets which normally would not be considered current may be readily sold to avert a liquidity squeeze. For example, a holding company may be participating in long-term loans originated by a Small Business Investment Company (S.B.I.C.) subsidiary. If these loans are of good quality, the parent's share may be sold at little or no discount to that S.B.I.C. subsidiary, another subsidiary, or an unaffiliated company to obtain the needed cash. Consequently, the breakdown of assets segregating those that are current would not necessarily be indicative of liquid assets, given the nature of bank holding company investments. Therefore, liquid assets are defined as those assets which are readily available as cash or which can be converted into cash on an ''arm's-length'' basis without considerable loss.

Liquidity problems are usually a matter of degree of severity. A less serious liquidity problem may mean that the company is unable to take advantage of profitable business opportunities. A more serious lack of liquidity may mean that a company is unable to pay its short-term obligations and is in default. This can lead to the forced sale of long-term investments and assets and, in its most severe form, to insolvency and bankruptcy.

4010.2.2 SUPERVISORY APPROACH TO ANALYZING PARENT COMPANY LIQUIDITY

For bank holding companies with consolidated assets in excess of $1 billion or material amounts of debt outstanding, or others, at the option of the Reserve Bank, the analytical approach to parent company liquidity will include the following key elements:

1. Beginning an evaluation of parent liquidity with an analysis of the *contractual* maturity structure of assets and liabilities, extended to consider the underlying liquidity of its intercompany advances and deposits. Any judgment of *adequate* parent company liquidity must be keyed to a finding that the parent has adequate liquid assets, on an underlying basis, to meet its short-term debt obligations.

2. Estimating the underlying liquidity of parent liabilities and assets, giving particular attention to interest bearing deposits in and advances to subsidiaries. Emphasis should be placed on asset quality and the liquidity profile of the bank and key nonbank subsidiaries. The estimates are to be reflected in a statement of ''Parent Company Liquidity Position'' as restated data with appropriate explanations as to the basis for the restatement.

3. Using the statement of ''Parent Company Liquidity Position'' which includes five contractual and estimated underlying maturity categories into which data is to be slotted. They are:

   a. Up to 30 days;
   b. Up to 90 days;
   c. Up to 1 year;
   d. One to two years; and
   e. Beyond two years.

   The schedule provides for the use of effective remaining maturity categories for the parent company's short-term assets and liabilities, highlighting funding surpluses or deficits at key specified periods of times. *Examiners have the option of including the statement in the inspection report to substantiate or clarify particular judgments.*

4. Using the conclusions drawn from the statement of parent company liquidity position as a basis for discussions with management. Examiners will also comment on their findings in detail on the ''Analysis of Financial Factors'' page in the inspection report.

5. Ascertaining that an organization with significant funding activities has in place:

   a. Internal parent liquidity management policies which address and limit the use of short-term funding sources to support various subsidiaries; and

   b. An internal *Contingency Plan* for maintaining parent liquidity under adverse situations.

4010.2.3 STATEMENT OF PARENT COMPANY LIQUIDITY POSITION

The purpose of the statement of ''Parent Company Liquidity Position'' is to provide a consistent method for analyzing parent liquidity. The schedule is *not* intended to address the issue of

interest sensitivity. While only conclusions drawn from the schedule of estimated, effective maturities are to appear in the inspection report, examiners should also collect data on contractual (remaining life) maturities of parent assets and liabilities. Examiners will treat all externally funded nonbank entities of the parent company in a similar fashion.

The maturity categories appearing on the schedule represent a basic analytical framework for looking at funding mismatches and are not necessarily appropriate for all organizations. As such, categories can be adjusted to fit particular circumstances. On a conceptual basis, the 30 day period corresponds to a period during which markets might be in temporary disarray due to an external shock. For the largest companies with substantial overnight and very short term funding operations, an additional one-to-seven-day category may be needed. The 31 to 90 day period allows for gauging the parent's ability to withstand internal adversity and demonstrate a return to ''normal'' business operations. The 91 to one year period is a reasonable planning horizon over which an organization might be able to readjust its internal funding policies substantially. In addition, the up to one year categories, as a group, complement the cash flow analysis of debt servicing capacity by specifically addressing maturing debt that must be either paid or rolled over at prevailing rates. The one to two year category provides an early indication of any funding imbalances that would have to be addressed by management in the reasonably near term. As a practical matter, the over two year category has limited analytical value in most cases and is included principally to make certain that all deposits and advances are accounted for.

Using these categories, funding surpluses or deficits can be identified for specific maturity intervals. Guidelines on acceptable practices for funding surpluses and shortfalls are set for the examiners in evaluating gaps based on estimated ''underlying'' maturities. Examiners would be expected to place particular emphasis on the up to 30 day period, where a net liquidity surplus would be expected to provide at least that much time for a parent to ride out a shock. Similarly, the up to 90 day period would be viewed as the relevant time to demonstrate to the market that problems are being addressed appropriately and are being brought under control. Imbalances in the 91 day to one year categories would generally have less significance, due to greater uncertainty regarding the assumptions that would go into any adjustments.

A logical point for assessing parent liquidity is an assessment of the contractual maturity structure of the holding company's balance sheet. Contractual maturities of assets and normal run-off of liabilities are to be slotted into the five maturity categories depicted. Once completed, the examiner is provided with an initial indication of whether the parent has an adequate cushion of short-term liquid assets within the 0 to 30 day and the 0 to 90 day categories to cover short-term liabilities or whether a pattern of significant short-term funding gaps exists. Certainly, the identification of such gaps gives guidance on obvious areas for further analysis. However, the absence of short-term funding shortfalls on a strictly contractual basis gives only limited comfort as the parent's underlying liquidity still must be analyzed more deeply.

4010.2.4 ANALYSIS OF UNDERLYING SOURCES TO FUND DEBT AND TO MEET OTHER OBLIGATIONS

Adjustments to the schedule that better reflect the parent's liquidity position will be made as the next step in the analysis. These adjustments require the examiner's judgment on the underlying liquidity of the parent's assets and liabilities with particular emphasis placed on interest bearing deposits with bank subsidiaries and advances to both bank and nonbank subsidiaries.

4010.2.4.1 Interest Bearing Deposits With Subsidiary Banks

The parent's interest bearing deposits[1] with the subsidiary bank(s) may represent either the temporary placement of idle funds or a more permanent source of bank funding. Temporary deposits typically are structured to mature in 90 days or less, are generally not substantial in relation to the overall size of the bank, are usually supported by substantial holdings of highly liquid bank assets, and could be repaid without triggering marketplace concerns regarding the organization's overall funding needs. Therefore, if this pattern exists, the temporary deposits may

1. In concept, the parent could also have advances to bank subsidiaries. Such advances are either booked as deposits (typically off-shore time deposits to avoid reserve requirements) or as instruments qualifying as Tier 1 or Tier 2 capital. To the extent that advances to banks are encountered, the analysis follows the same approach as with deposits.

be considered highly liquid and slotted in the 0 to 30 day (or 0 to 7 day) period on the schedule, regardless of their contractual maturity dates.

Interest bearing deposits with the subsidiary bank(s) that serve as a permanent source of bank funds are typically substantial in relation to the size of the bank and are usually placed to fund bank expansion without additional bank borrowings. Here, judgments regarding underlying liquidity should be keyed to the CAMELS ratings on the bank's liquidity and asset quality as well as reasoned judgments on the bank's ability to liquidate assets and/or replace the funds in the marketplace through additional borrowings. Asset quality is regarded as critical as it is a leading indicator of bad news that will ultimately pull down earnings and undermine market confidence. As a general principle, the liquidity of the parent's deposits in bank(s) should be no better than the liquidity of the bank(s), and subject to downgrading if bank asset quality is suspect. If bank asset quality is worse than fair, the liquidity of these funds should be downgraded. For banks with asset quality rated fair, the parent's deposits might still be considered liquid, but a closer analysis of the particular situation would be warranted.

Under the assumption that the bank's asset quality and liquidity positions do not negatively impact the bank's ability to liquidate or replace these funds, such deposits may be slotted in the 0 to 30 day (or 0 to 7 day for large institutions) period on the schedule regardless of the contractual maturity. However, if these deposits are substantial, their replacement may trigger market concerns. At this point, the examiner's judgment is necessary regarding an acceptable level at which a portion of the deposits could be replaced in the marketplace without triggering such concerns. A starting point for the examiner should be to evaluate the funding gaps appearing on the contractual maturity schedule with particular attention paid to the 0 to 90 day period (0 to 30 days for large institutions). While it may be impossible for the bank(s) to replace all the parent's deposits without triggering concerns, the bank(s) may be able to replace only the portion necessary to eliminate the negative cumulative funding gap in the given time period. If even this amount is deemed to be substantial, the examiner may have no other alternative but to treat the deposits in accordance with the contractual maturity. For clarification purposes, the following example is provided:

The contractual maturity schedule of a large holding company reflects a negative cumulative gap of $400 million in the 0 to 30 day time frame. The company's balance sheet includes $2.5 billion in interest bearing deposits at the subsidiary bank(s), with $1 billion maturing in 30 days and $1.5 billion in 31 to 90 days.

In the examiner's judgment, the entire $1.5 billion due in over 30 days qualify to be slotted in the under 30 day category,[2] but the bank would face liquidity pressures to replace this amount prior to its original maturity. However, $400 million, the amount needed to eliminate the negative cumulative gap position, could be replaced by the bank without undue market concern. Therefore, $400 million from the 31 to 90 day period should be reslotted in the appropriate under 30 day period.

4010.2.5 ADVANCES TO SUBSIDIARIES

Given the typical composition of bank holding company assets, the examiner is likely to encounter difficulty in determining the degree of liquidity inherent in advances to subsidiaries.

For those subsidiaries with satisfactory asset quality, the examiner can usually assume the subsidiary could sell qualifying assets to affiliate bank(s) up to the quantitative limitations of section 23A, as long as the affiliated bank(s) are judged to have adequate liquidity. The examiner can also assume that the subsidiary, with an established program of secondary market asset sales, could at least continue or even modestly expand the scope of the program. For subsidiaries without a program of asset sales, but whose assets are of the type that are readily marketable in the secondary market, a *limited* asset sale program could be considered to provide some asset liquidity. However, caution should be used in estimating the magnitude of such sales, particularly because large transactions could not be accomplished quickly without risking market visibility and broadcasting concerns regarding the corporation's funding.

When nonbank advances are substantial, the parent has little or no practical access to the funds advanced. While an arm's-length sale of such a subsidiary or a large portion of its assets to a bank affiliate may not generate a loss, the funding requirements for a large transaction at the bank level would probably initiate market-

2. Subject to early withdrawal penalties which will be eliminated in consolidation.

place concerns.[3] Similarly, significantly above normal asset sales to an unaffiliated party would not only trigger market concerns, but would probably also result in a significant discount. Furthermore, although it is possible that another nonbank subsidiary may act as the funding vehicle, the subsidiary's ability to generate the required funds may be restricted at best. Such restrictions may include marketplace concerns as well as limitations on the maximum leverage positions or creation of senior debt imbedded in debt covenants.

Advances to a subsidiary may be either short-term or long-term and are made for a variety of reasons, including providing a temporary source of income for the parent, enhancing a subsidiary's liquidity position, and supporting a subsidiary's operations. Therefore, the purpose of the loan, its maturity, as well as the degree to which high quality assets of a subsidiary cover the amount due to the parent, should also be considered in order to properly categorize advances.

4010.2.6. LIQUIDITY AND LIABILITIES OF THE PARENT

In regard to liabilities of the parent, the policy presumption should be that their contractual maturity reflects the underlying availability of funds. Exceptions will reflect special circumstances, such as funding from foreign ownership interests or partners in joint ventures who have equity interests and an ongoing business relationship. The presence of back-up lines of credit for commercial paper, while especially desirable in the case of regional companies, should not, by itself, cause an examiner to assume that the underlying maturity of a parent's short-term debt is materially longer than its contractual term, or that these lines will always be readily available. In fact, organizations experiencing considerable problems, particularly asset quality and liquidity, have found that these facilities are no longer available.

The examiner should thus review back-up lines on a case-by-case basis and be aware of any escape clauses in interbank agreements. Specifically, for companies with a composite "3" or worse BOPEC rating *or* lead banks with asset quality of a declining "3" or worse *or* where asset quality *and* liquidity are rated "3" or worse, it is recommended that back-up lines with "material adverse change" or similar escape clauses *not* be regarded as satisfactory support to an imbalanced parent company funding position.

Furthermore, certain holding companies' liabilities may often include unamortizing debt instruments. The company's ability to retire or replace such issues at maturity should be evaluated as part or the organization's overall liquidity analysis. If it is the intention of management to roll over the maturing issues, the evaluation should be based on the company's ability to do so. In cases where debt retirement is the route chosen by management, the examiner's evaluation and judgment should focus on the company's ability to generate the necessary funds either through asset liquidation or the issuance of equity instruments.

The unamortizing portion of debt issues is to be slotted in the appropriate maturity column of long-term debt. If the maturity of such issues falls due within the 0 to 90 day time frame, the examiner should comment on the organization's ability to replace the maturing issues or retire them by the deployment of funds from other sources in a footnote on the schedule. If the maturity of such debt is longer, the replacement or retirement should be addressed in the corporation's funding plan.

4010.2.7 ANALYZING FUNDING MISMATCHES

After adjustments for the underlying liquidity of the parent's interest bearing deposits and advances to subsidiaries and the underlying maturity of its liabilities, the resulting schedule should provide the examiner with the framework for looking at funding mismatches as a tool for assessing the parent's overall liquidity position. The position may be evaluated by the analysis of the underlying liquidity gaps (appearing on the bottom of the schedule). In the 0 to 30 day time frame, a net positive gap is expected and reflects the parent's ability to ride out a temporary market disarray. Although a negative gap in the 8 to 30 day period may be evident in larger organizations, the overall 30 day interval is expected to be positive. Similarly, for most organizations, the 0 to 90 day period is expected to reflect a positive position, regardless of a shortfall in the 31 to 90 day period. Failure to meet these conditions requires appropriate examiner comments on the "Examiner's Comments" page of the report.

The 91 day to 1 year time frame (as well as

3. Underlying liquidity estimates should follow the same approach previously stated for deposits.

the 31 to 90 day period for certain larger organizations) is less critical, and negative cumulative funding positions of modest size may be tolerated if the organization has demonstrated an ability to tap the funding markets, has readily available backup lines of credit, has a reasonable earnings retention policy, adequate funds flow coverage and other fund generating programs such as a dividend reinvestment plan. Judgments on the reasonableness of any imbalances in these longer term categories should be weighed against the examiners' estimates as to the adequacy of these sources. In addition, the examiner should view these longer periods as a reasonable planning horizon over which the organization should be able to readjust its funding policies as well as provide an early indication of how funding imbalances, that may develop, are to be addressed by management.

A significant shortfall in the 91 day to 1 year period is expected to be covered by a contingency funding plan. While no single formula for such plans is recommended or possible, each organization needs to address its own particular situation and the options it faces. At minimum, the organization needs to address possible market shocks whether caused by its own actions or by external events. Funding markets should be addressed individually and as a group both as to their likely resiliency and the particular organization's position within each market. Contingency sources should be tested periodically as to their viability. The examiner should review the reasonableness of assumptions and adequacy of alternative courses as part of the company's liquidity analysis. Where no plan exists, a plan acceptable to the corporation's directors should be required. Even if there are no specific concerns, the existence or lack of a plan should be taken into account when assessing management.

In analyzing liquidity, the examiner will encounter the least difficulty when liquid assets equal or exceed short-term liabilities. In those instances, the liquidity position is considered adequate. If the examiner notes a declining trend in the liquidity position, an appropriate comment may be warranted, even though sufficient liquidity exists at that time.

Conversely, the examiner will encounter the most difficulty in analyzing liquidity when liquid assets are not sufficient to cover short-term obligations. When this situation exists, it is not necessarily indicative of an inadequate liquidity position. At that point, the examiner must consider other readily available sources of cash not shown on the balance sheet (e.g., unused bank lines, dividends from subsidiaries).

Footnotes to financial statements may also play an important role in such an analysis. One such footnote may be indenture restrictions on long-term debt. While a company may temporarily alleviate a liquidity bind by paying off its commercial paper with short-term bank loans, it may be faced with the problem of paying off the bank debt if it is precluded from issuing additional long-term debt.

4010.2.8 REPORTING THE RESULTS OF THE ANALYSIS

In the normal course of the inspection, the examiner should present his conclusions concerning liquidity to management. Where there is an indication of some vulnerability, the examiner should solicit management's opinion and any corrective action plans being considered. If it appears that management has not addressed itself to the vulnerable or inadequate situation, an appropriate comment should be made. The results of this analysis should be discussed in the parent company section on the ''Analysis of Financial Factors'' page in the inspection report. In addition, the examiner has the option of incorporating the liquidity schedule in the report to substantiate or clarify particular judgments. Criticism with respect to a liquidity shortfall anywhere within the 0 to 90 day time frame or, in most cases, the absence of a Contingency Plan to cover shortfalls in the under 1 year time frame, should be carried forward to the ''Examiner's Comments'' page, the transmittal letter, and be included in discussions with management.

4010.2.9 INSPECTION OBJECTIVES

1. To analyze the contractual maturity structure of assets and liabilities, and then extend the analysis to the underlying liquidity of intercompany advances and deposits, considering whether the underlying liquidity is short-term or long-term in nature.

2. *To estimate the underlying liquidity of parent liabilities and assets,* with particular attention to interest bearing deposits in, and advances to, subsidiaries. Place emphasis on:

   a. Asset quality; and

   b. The liquidity profile of the bank and key nonbank subsidiaries.

3. To restate the estimates on the analysis of

''Parent Company Liquidity Position'' using the suggested *5 broad contractual and underlying maturity categories.*

4. *To judge the adequacy of parent company liquidity,* keying it to a finding as to whether the parent has adequate liquid assets, on an underlying liquidity basis, to meet its short term debt obligations.

5. For *BHC's that have significant funding activities* at the parent level, to determine if the parent company has in place:

a. *Internal parent liquidity management policies* which address and limit the use of short term funding sources to support subsidiaries.

b. An internal *Contingency Plan* for maintaining parent liquidity in the face of adversity.

6. To draw conclusions from the estimated remaining effective maturities that appear in the report.

4010.2.10 INSPECTION PROCEDURES

1. Assess the contractual maturities of the parent company's balance sheet.

2. Slot the contractual maturities of assets and normal runoff of liabilities into the five categories on the ''Parent Company Liquidity Position'' page.

3. On the schedule, make adjustments, as to the underlying maturity of the parent company's assets and liabilities.

4. Review funding mismatches.

5. *Review the reasonableness of the Contingency Plan's assumptions and adequacy of alternative sources*.

a. If no plan exists, a plan acceptable to the corporation's directors should be required.

b. Even if there are no specific concerns, the existence or lack of a plan should be taken into account when assessing management.

6. Discuss the results in the parent company section of the ''*Analysis of Financial Factors*'' page in the inspection report.

7. Include in the ''*Examiner's Comments*,'' page 1, *criticism of liquidity shortfalls within the 0 to 90 day period or the absence of a contingency plan to cover shortfalls in the under one year time frame,* that were discussed with management.

In making the determination as to the condition of the holding company under inspection, an examiner must, as part of his examining procedure, focus his efforts on analyzing the financial condition of the bank(s) owned by the holding company. Such an appraisal is obviously of paramount importance when one considers that the bulk of the consolidated assets and earnings of a holding company are represented by the bank(s). The examiner must incorporate in the analysis, results of the most recent commercial examination of the subsidiary bank(s).

Therefore, for meaningful results, the analysis of the subsidiary bank(s) should commence after the results of the latest examination of the bank(s) have been obtained. The examiner in his analysis of the bank must consider and determine whether certain key facets of a bank's operations meet minimum standards and conform, where required, to bank regulatory restrictions. Areas of principal concern are: capital adequacy, asset quality, earnings, liquidity, and quality of management. The examiner should be especially alert to any exceptions or violations of applicable statutes or regulations that could have a materially adverse effect upon the financial condition of the organization. In addition, the examiner should also consider the conclusions drawn as to the extent of compliance and the adequacy of internal bank policies that contribute to the overall analysis of the bank's condition.

Inspection personnel should use the examination ratings of the other federal agencies (where appropriate) when completing the inspection report. However, if substantive differences of opinion exist as to the bank's composite rating, adjustments to the rating may be made and footnoted to indicate the change.

One area of vital importance in the evaluation of a bank's condition is capital adequacy. Consideration should be given by the examiner whether the bank has sufficient capital to provide an adequate base for growth and a cushion to absorb possible losses, thereby providing protection to depositors. In that regard, the Board, has adopted capital adequacy guidelines, that include risk-based and leverage measures which apply to state member banks. The examiner should refer to section 303.1 of the *Commercial Bank Examination Manual* for guidance on evaluating the capital adequacy of state member banks.

The quality of a bank's assets is another area of major supervisory concern. Indeed, supervisors consider the appraisal and evaluation of a bank's assets to be one of the most important examination procedures. It will be established by the bank examiner during the examination of a subsidiary bank to what degree its funds have been invested in assets of good quality that afford reasonable assurance of ultimate collectibility and regularity of income. The examiner should have further determined that a subsidiary bank's asset composition is compatible with the nature of the business conducted by the bank, the type of customer served, and the locality. The holding company examiner is expected to comment upon the total classifications determined by the bank examiner in relation to the bank's capital. Consideration should also be given to the severity of the classifications. If the classified assets are considered not to possess a significant loss potential, favorable consideration should be accorded this factor.

Past due ratios should also be evaluated. In this respect, it is essential that trends be observed. Although a particular lending department's delinquent outstandings or an institution's overall past due percentage is presently considered reasonable, a noticeable upward trend may be worthy of comment to management. Excessive arrearages in any area warrant an examiner's comment in the inspection report. It behooves management to take appropriate action to improve any undesirable past due levels.

In determining an organization's asset quality, one effective yardstick employed by examiners is the ''weighted average'' of classifications, which takes into consideration the severity of a bank's classified assets. In rating asset quality, the ''weighted average'' of classifications system is designed to distinguish the degree of risk inherent in classified assets by ascribing weights to each category of classification thereby providing a more reliable measure of the impact of risk on bank capital.

The following weights are to be used:

Classification	*Weights*
Substandard	20%
Doubtful	50%
Loss	100%

The ratio of weighted classifications to Tier 1 capital is the primary criterion to be used in determining the quality of assets. However, examiners should also evaluate the adequacy of loan loss valuation reserves as compared to weighted classifications. Loss potential inherent in weighted classified assets must be offset by valuation reserves and equity capital or appropriate comments should be made.

Another tool that should be considered in evaluating asset quality is the bank's internal classification list, if the bank's lending procedures and management are adequate. Additional information on rating a bank's asset quality is available in the Uniform Interagency Bank Rating System.

Comparison of earnings trends with other banks of similar size, along with an analysis of the quality of those earnings, is probably the best initial approach in determining whether or not a bank's earnings are satisfactory. Comprehensive surveys of bank earnings by peer group size are tabulated by the Board and many of the Reserve Banks. The results are sufficiently detailed to permit various methods of comparison of the earnings of a specific bank with those in its peer group.

One ratio used as a means of measuring the quality of a bank's earnings is its return on average assets (net income after taxes divided by average total assets). If the ratio is low or declining rapidly, it could signal, among other things, that the bank's net interest income or margin is declining or that the bank is experiencing increased loan losses.

A bank's current earnings should be sufficient to allow for ample provisions to offset anticipated normal losses. Various factors to be considered in the determination of such losses include a bank's historic loss experience, the adequacy of the valuation reserve, the quality and strength of its existing loans and investments and the soundness of the loan and administrative policies of management.

In assessing a bank's earnings performance capabilities and the quality of those earnings, an examiner should give consideration to any special factors that may affect a particular bank's earnings. For example, a bank located in an urban area of a large city may find it difficult to earn as much as a bank of similar size located in a rural community or a small city. The urban bank is usually subjected to a higher level of operating expenses, particularly in salaries and local taxes. Moreover, its proximity to the large city and the competition afforded by bigger banks may necessitate lower rates of interest on loans as well as higher rates of interest on time deposits. Consideration should also be given to the adequacy of the loan loss provisions as referred to above, the inclusion of any capitalized accrued interest into interest income, or the nature of any large nonoperating gains when analyzing earnings. Further consideration should be given to the general nature of a bank's business or management's mode of operation. A bank's deposit structure and its resulting average interest paid per dollar of deposits may differ widely from that of other banks of a similar size and consequently, its earnings may be substantially below average as a direct result of the difference. For example, the maintenance of a high volume of interest bearing time accounts in relation to total deposits is a major expense and is quite often the cause for certain banks falling below the average earnings of comparably sized banks.

A bank's earnings should also be adequate in relation to its current dividend rate. The percentage that should be retained in the capital accounts is not clearly established. One thing is certain, the need for retained earnings to augment capital will depend on the adequacy of the existing capital structure as well as the bank's asset growth rate. Dividend payout rates may be regarded as exceeding prudent banking practices if capital growth does not keep pace with asset growth. Prudent management dictates that a curtailment of the dividend rate be considered if capital inadequacy is obvious and greater earnings retention is required. Apparently excessive dividend payouts or a record of recent operating losses should lead the bank or BHC examiner to refer to sections 5199(b) and 5204 of the United States Revised Statutes and section 208.19 of Regulation H which restrict state member bank dividends.

Analysis of net interest margins is of growing importance. A comparison should be made of a bank's ability to generate interest income on earning assets relative to the interest expenses associated with the funds used to finance the earning assets.

Additional information on rating bank earnings is available in the Uniform Interagency Bank Rating System.

Liquidity is generally defined as the ability to meet short-term obligations, to convert assets into cash or to obtain cash, or to roll-over or issue new short-term debt. Various techniques are employed to measure a bank's liquidity position. The bank examiner considers its location and the nature of its operations. For example, a small rural bank has far different needs than a multi-billion dollar money market institution.

In addition to cash assets, a bank will hold for liquidity purposes a portion of its investment portfolio of securities that are readily convertible into cash. Loan and investment maturities are generally matched to certain deposit or other liability maturities. However, the individual responsible for a bank's money management must be extremely flexible and have alternate means to meet unanticipated changes in liquidity needs. To offset these needs, other means of increasing liquidity may be needed which might include increasing temporary short-term borrowings, selling longer-term assets, or a combination of both. Factors which the ''money management'' officer will consider include the availability of funds, the market value of the saleable assets, prevailing interest rates and the susceptibility to interest rate risk, and the bank's earnings position and related tax considerations. Although most small banks do not have a ''money manager,'' they too must monitor their liquidity carefully.

One of the most common methods used by large banks to increase liquidity is to use additional short-term borrowings. Some of the other basic means of improving liquidity include the use of direct short-term credit available through the discount window from Reserve Banks, the use of Federal funds purchases and the use of loans from correspondent banks.

A bank's liquidity must be evaluated on the basis of the bank's capacity to satisfy promptly its financial obligations and its ability to fulfill the reasonable borrowing needs of the communities it serves. An examiner's assessment of a bank's liquidity management should not be restricted to its liquidity position on any particular date. Indeed, the examiner should also focus his efforts towards determining the bank's average liquidity over a specific time period. The evaluation should encompass the overall effectiveness of asset-liability management strategies. Factors such as the nature, volume and anticipated take-down of a bank's credit commitments, should also be considered in arriving at an overall rating for liquidity.

If the bank examiner has commented on a liquidity deficiency at a subsidiary bank, the holding company examiner should consider these findings in the overall analysis of financial factors.

Additional information on rating a bank's liquidity is available in the Uniform Interagency Bank Rating System.

The condition of a bank provides important insight regarding the quality of bank management. An appraisal of management's performance should be measured in terms of long-term profitability, risk exposure, liquidity, and solvency; all geared toward assuring the bank's continued profitability and overall sound financial condition. Management must meet the bank's challenges and position in the market place among its competitors. It must make plans which will achieve the objectives established by the bank's directors. Management must be constantly alert to the need for continued upgrading and expanding of services and facilities to advance, support, and encourage the bank's growth.

Just as sound management decision making will generally produce banks that are free from serious problems, ineffective management has invariably been a prominent factor in almost every serious problem bank situation. An examiner must consider the degree and severity of problems that exist in the bank under examination and attempt to establish the responsibility for such. The examiner should seek to determine to what degree the bank's problems are attributable to questionable management judgment as opposed to outside factors, such as unfavorable economic conditions.

As indicated at the beginning of Part IV, the major portion of the holding company's consolidated assets are held in the bank subsidiaries. Furthermore, at the parent level, the major asset is generally the investment in subsidiaries, the principal portion of which is the investment in the bank(s). Therefore, with few exceptions, it is the overall condition of the bank subsidiaries that reflects the condition of the parent company. As the holding company examiner reviews the examination report(s) for each bank subsidiary, a decision must be made with respect to the general condition of each bank. When all the bank subsidiaries have been reviewed, the examiner must put these findings within their proper perspective. For example, if four of five bank subsidiaries comprise less than 10 percent of the combined banking assets, it is the condition of the fifth bank subsidiary that will weigh heavily in the analysis. In other words, if the fifth bank comprises 90 percent of the combined banking assets, the parent's investment in that bank also comprises most of the holding company's assets. Thus, the quality of the parent's assets would be reflected in the general condition of that bank and appropriate comments are warranted. It should be noted, however, that regardless of relative size, a bank experiencing problems should be commented upon in the summary analysis.

4020.9.1 DEFINITION AND SCOPE OF THE DE NOVO BANK SUPERVISION POLICY

The term ''de novo bank'' refers to a state member bank that has been in operation for five years or less. The application and supervision standards for de novo state member banks are found in SR-91-17. De novo state member bank subsidiaries of bank holding companies are subject to those policies. The standards discussed in this section are limited to a de novo subsidiary bank's financial performance.

The de novo policy also extends to commercial banks that have been in existence for less than five years and subsequently convert to membership. Because thrifts, Edge Act companies, and industrial banks that are converting to membership (''converted banks'') have not demonstrated operating stability as commercial banks, they also are subject to the de novo policy, regardless of how long they existed before the conversion.

The policy applies to de novo banks through the fifth year of operations. Experience has shown that pronounced problems often surface during a new bank's fourth and fifth years of operation, frequently as a result of inexperienced management, management and director changes, dissension among directors, directors' lack of involvement, and poor lending practices during the early years.

4020.9.2 CAPITAL STANDARDS FOR SUBSIDIARY BANKS OF BHCs

De novo subsidiary banks of bank holding companies are expected to maintain capital in conformance with the de novo policy guidelines of SR-91-17. Initial capital in a de novo state member bank should be reasonable in relation to state law, the bank's location and business plan, and the competitive environment. At a minimum, a de novo bank must maintain a tangible Tier 1 leverage ratio of 9 percent for the first three years of operation.[1] The applicant's (that is, the proposed state member bank's or the bank holding company's) initial projections of asset growth and earnings performances should be reasonably in line with the bank's ability to maintain this ratio without relying on additional capital injections. The de novo policy also applies to newly converted commercial banks through the third year of existence and to other types of institutions that become Federal Reserve members for a three-year period beginning from the date following consummation. Any exceptions to this policy that are being considered for converted banks should be discussed with Board staff. Although a 9 percent tangible leverage ratio is not required after year three, de novo banks are expected to maintain capital ratios commensurate with safety-and-soundness concerns and, generally, well in excess of regulatory minimums.

4020.9.3 CASH FLOWS TO A BHC PARENT

Under the current policy on small one-bank holding companies (see section 2090.2.3), de novo banks may not provide funds for servicing the parent's debt until the bank receives two consecutive CAMELS ratings of 1 or 2 based on full-scope examinations and, in the judgment of the Reserve Bank, can be expected to continue operating soundly. An exception to this prohibition is the tax payments that are made in accordance with the Board's policy under Regulation Y (see section 2070.0 and *FRRS* 4–870).

1. Although this policy applies to a bank holding company's acquisition of a de novo state member bank, the Federal Reserve also encourages bank holding companies' nonmember bank subsidiaries to adhere to the same standards.

4030.0.1 INTRODUCTION

Generally, a subsidiary of a bank holding company is not liable for debts of any other subsidiary of the holding company unless it is contractually obligated through guarantees, endorsements, or other similar instruments. This apparent legal separation may induce false confidence that banks are insulated from problems that may befall other subsidiaries of the holding company. If a nonbank subsidiary of a bank holding company finds itself in serious financial trouble, several results are possible. The holding company may work as it was intended, in that debts of the failing subsidiary are isolated and not transferred to other subsidiaries so that at worst, the subsidiary and the parent (the holding company) fail. In this instance, other subsidiaries, including bank subsidiaries, are unharmed, and after a change in management or ownership, they continue in operation. There is no loss of confidence in the bank by its depositors. However, this is not necessarily the result.

Failure of a nonbank subsidiary may lead to a lack of confidence in the affiliated bank's ability to continue in business, which might precipitate a run on the bank's deposits. The failure of a major nonbank subsidiary then may place its affiliated bank in serious financial trouble. The examiner should assess the impact that the failure or the potential failure of a nonbank subsidiary may have on an affiliated bank with a similar name.

Usually, a financially distressed nonbank subsidiary is aided by the holding company, which will do everything in its power to rescue it from failure. At a minimum, refusal to do so would undermine confidence in the strength of the holding company. Refusal to aid its nonbank subsidiary might even result in a rise in the interest cost of the holding company's future debt in the capital markets and, more than likely, preclude issuance of commercial paper.

A holding company has considerable discretion in choosing how to assist one of its troubled subsidiaries. Because the bank is usually the largest subsidiary, the holding company may attempt to draw upon the resources of the bank to aid the nonbank subsidiary. The bank can transfer a substantial portion of its capital through dividends to the parent company, which may pass these funds on to the troubled nonbank subsidiary. Also, the nonbank may attempt to sell part of its portfolio to the bank subsidiary to improve liquidity. The Board's Interpretation 12 C.F.R. 250.250 (at FRRS 3–1133) limits the sale of nonbank subsidiary loans to the bank affiliate unless the bank had an opportunity to appraise the credit at the inception of the loan. Therefore, the examiner should closely analyze the off-balance-sheet activity of the nonbank subsidiary, particularly activity relating to the sale of loans shortly after they are made. Reference should also be made to section 2020.7, regarding the transfer of low-quality loans or other assets to avoid classification.

4030.0.2 ANALYSIS OF FINANCIAL CONDITION AND RISK ASSESSMENT

Because of the potentially damaging effect on the parent company or its bank subsidiary, the examiner should conduct a detailed analysis of the financial condition and perform a risk assessment of the nonbank subsidiaries. The loss to the holding company may not be confined to the equity in and advances to the subsidiary. The contingent liabilities arising from the nonbank subsidiary's external borrowings are quite often a large multiple of the parent's investment. Particular attention should be directed to holding companies that have made massive capital injections in order to rescue a failing subsidiary or to satisfy the external debt obligations of the subsidiary.

For each bank holding company with nonbank activities, examiners should prepare a written risk assessment of each active nonbank subsidiary, addressing the financial and managerial concerns outlined below.[1] This assessment should be performed with the same frequency required for full-scope inspections. The purpose of this assessment is to identify subsidiaries with a risk profile that warrants an on-site presence, even if the subsidiary does not meet the minimum criteria set forth in section 5000.0.4.4.1, ''On-site Reviews of Nonbank Subsidiaries.'' In formulating this assessment, the examiner should consider all available sources of information including, but not limited to—

- findings, scope, and recency of previous inspections;

1. The assessment of nonbank activities in large, complex organizations may be focused on an intermediate-tier company with oversight responsibility for multiple nonbank subsidiaries.

- ongoing monitoring efforts of surveillance and financial analysis units;
- information received through first-day letters or other pre-inspection communications;
- regulatory reports and published financial information; and,
- reports of internal and external auditors.

The risk assessment should address each nonbank subsidiary's funding risk, earnings exposure, operational risks, asset quality, capital adequacy, contingent liabilities and other off-balance-sheet exposures, management information systems and controls, transactions with affiliates, growth in assets, and the quality of oversight provided by the management of the bank holding company and nonbank subsidiary. The examiner should give particular attention to appraising the quality of a nonbank subsidiary's assets because asset problems therein may lead to other financial problems in the nonbank subsidiary and the parent company or bank affiliates. Examiners are expected to document in the inspection workpapers their assessment of the overall risk posed by each nonbank subsidiary and to summarize their assessment of nonbank activities in the bank holding company inspection report.

The examiner has four alternatives with respect to asset classifications. An appraisal of the degree of risk involved in a given asset leads to a selection. The examiner can either ''pass'' the asset or adversely classify the asset ''substandard,'' ''doubtful'' or ''loss,'' depending on the severity of deterioration noted.

Since the preponderance of all loans are subject to some degree of risk, the following question arises: To what point, or degree, must a given credit deteriorate to warrant a scheduled criticism in the report of inspection? Generally, a passed credit has those characteristics which are recognized as being part of a normal risk asset; the degree of risk is not unreasonable, the loan is being properly serviced, and is either adequately secured or repayment is reasonably assured from a specific source.

Classification units are designated as ''substandard,'' ''doubtful,'' and ''loss.'' A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the nonbank subsidiary will sustain some loss if the deficiencies are not corrected. An asset classified doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. Assets classified loss are considered uncollectible and of such little value that their continuance as recordable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer reserving against this basically worthless asset even though partial recovery may be effected in the future.

Although the System does not apply bank standards when classifying nonbank assets, the classification categories are the same. Examiners of BHC nonbank subsidiaries must appraise the assets in light of industry standards and conditions inherent in the market.

For information on classifying a parent's investment in and advances to a noncredit-extending subsidiary, see Manual section 4070.0, BHC Rating System.

For information on the sufficiency of nonbank valuation reserves, see Manual section 4030.4.

When analyzing the earnings of a nonbank subsidiary, the examiner should address two primary questions: (1) Is the return on assets commensurate with the risk associated with the assets? (2) What is the impact of earnings and trends on the parent company and affiliate banks? While a nonbank subsidiary operating at a loss may be in less than satisfactory condition, the loss may not necessarily result in a major adverse impact on the consolidated earnings. The nonbank subsidiary's total assets may be insignificant in relation to the consolidated assets of the BHC, but operating losses may result in a significant reduction in its consolidated earnings position.

In some cases, industry statistics will be available for comparative purposes. However, a favorable comparison should not necessarily be taken as depicting a satisfactory earnings condition. Actions by the parent company could influence the earnings of its subsidiaries. For example, management and/or service fees can be adjusted in order to alter the subsidiary's earnings to desired levels. Also, if the parent company is funding the subsidiary, the cost of funds to the subsidiary can be adjusted above or below the parent's cost of funds thus affecting net income. In addition, an undercapitalized subsidiary with only a marginal return on assets could show a better return on equity than the adequately capitalized independent counterpart experiencing a good return on its assets. As important as return on equity is as a measure of performance, for nonbank subsidiaries, particularly those that are thinly capitalized, absolute level of earnings or return on assets provide a more meaningful measure of earnings performance.

The cash return to the parent from its investment in and advances to a subsidiary less its costs to carry the assets and related expenses should exceed the cash return available from an investment of a similar amount in securities in order to justify retaining the subsidiary. If it seems that an alternative employment of funds would be more rational, the examiner should inquire as to management's plans to improve subsidiary earnings.

Questions to be answered in analyzing the earnings of credit-extending nonbank subsidiaries include:

1. What is the impact on the parent company and affiliate banks of a nonbank subsidiary operating at a loss?
2. Is the return on assets commensurate with the risk inherent in the asset portfolios for those nonbank subsidiaries operating profitably?
3. Are intercompany management/service fees appropriate? From a supervisory perspective, management and service fees should have a direct relationship to and be based solely upon the fair value of goods and services received.
4. Is the subsidiary required to reimburse the parent for the parent's interest expense on borrowed funds, the proceeds of which have been treated as ''advances to subsidiaries?''
5. Is the quality of the subsidiary's earnings sound? For example, is the company understating the provision for loan losses, relying upon nonoperating gains or capitalization of accrued interest?

Special attention should be directed by the examiner to the computation of the company's net interest margin (interest income–interest expense, divided by average earning assets). A study of company yields on investments should provide a measure of the company's ability to invest its funds in earning assets that provide a rate of return above the company's cost of funds. As net interest margins narrow, the company may find it more difficult to generate sufficient income to meet operating expenses.

When discussing growth in earnings, the examiner should clearly differentiate between increases due to increased net interest income on a constant base of earning assets as compared to an increase in the earning asset base with a concurrent proportional increase in net interest income. Any improvement in net interest income as a percentage of earning assets may reflect favorably on management's ability to invest its funds at favorable yields or its ability to find less expensive sources of funds.

As a general rule, credit-extending nonbank subsidiaries are funded by the proceeds of parent company borrowings through instruments such as commercial paper or medium to long-term debt or a combination thereof. Equity generally represents only a small portion of funding resources. There are instances, however, where the nonbank subsidiary will arrange direct funding from external sources. This is especially true in certain States where there are tax advantages associated with direct external funding.

Heavy reliance on borrowed funds by a nonbank subsidiary together with its limited capital position often results in a highly leveraged financial condition that is quite sensitive to changes in money market cost of funds. An examiner should consider what a change in the company's cost of funds might do to its net interest margin and earnings.

Many BHCs operate on the premise that a nonbank subsidiary needs little capital of its own as long as the parent company is adequately capitalized. Implicit in this operating practice is management's belief that the parent could act as a source of financial strength to its subsidiary in the event of difficulty at the subsidiary level. However, experience has indicated that in many cases, once trouble has developed in the subsidiary, the parent is hesitant to direct additional funds to the subsidiary, arguing that it is best to limit losses and exposure and it is imprudent for the parent to inject additional capital at this time. Given this experience, it is often considered appropriate for an examiner to comment on a subsidiary's extended leveraged position, indicating to management that the company has little, if any, capital ''cushion'' with which to absorb any asset ''shrinkage'' or loss. The examiner may then conclude and possibly recommend that additional capital be provided for the credit-extending nonbank subsidiary so that its leverage may be reduced and its capital structure altered to reflect more closely an independent organization in the same or similar industry.

Funding should be reviewed to determine that the subsidiary (or the parent) is not mismatching maturities by borrowing short-term funds and applying them to long-term assets that are not readily convertible into cash. A mismatch of maturities can lead to serious liquidity problems.

A primary concern of the holding company examiner is to determine whether the nonbank subsidiary has the capacity to service its debt in an orderly manner. Does the credit-extending nonbank subsidiary have sufficient liquidity and how much will it have to rely on the parent company for funds to retire debt to unaffiliated parties? Factors to be considered include:

1. The subsidiary's asset quality and its ability to convert assets into cash at or near current carrying value. Consider the maturities of borrowings and whether they align with the scheduled assets that will be converted to cash.

2. The subsidiary's and the parent's back-up bank lines of credit available in the event commercial paper cannot be refinanced.

3. The parent company's ability to require its bank or other nonbank subsidiaries to upstream extra dividends to support the illiquid position of one or more of its nonbank subsidiaries.

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The purpose of a credit-extending nonbank subsidiary's reserve for bad debts is to provide for known and potential losses in its assets. Although there is no specific formula for measuring the adequacy of a reserve for bad debts, prudence dictates that the reserve account should be maintained at a ''reasonable'' level. What is reasonable depends on the quality of the subsidiary's assets, its collection history and other facts. However, from a supervisory perspective, the reserve for bad debts should at least provide total coverage for all assets classified ''loss'' and still be sufficient to absorb future, unidentified, ''normal'' losses, that are estimated based on the ''doubtful'' and ''substandard'' classifications and the company's historic experience. Valuation reserves for a going concern are not considered adequate unless they can absorb 100 percent of identified losses and still have a balance sufficient to absorb future losses from continued operations.

Examiners should recommend the maintenance of valuation reserves sufficient to offset classified losses and may recommend (as opposed to require) that management charge-off the losses to the reserve account. The charge-off of classified losses is considered appropriate in order to assure that financial statements accurately reflect the company's financial condition. The Federal Reserve System has the responsibility to monitor the bank holding company's nonbank subsidiary statements for accuracy and completeness. Failure by management to reflect accurately the financial condition of the subsidiary and/or parent company could result in a formal corrective action to require charge-offs or other adjustments to financial statements.

For additional information, see Manual section 4030.1, ''Classifications.''

The noncredit-extending nonbank subsidiaries provide services or financial products other than extensions of credit. Some of these companies are insurance agencies, credit life and credit accident and health insurance underwriting companies, electronic data processing centers, management consulting firms and advisory companies.

The operations of some insurance agencies are conducted on the premises of the bank subsidiary(ies) by personnel who often serve as officers or employees of the bank. These companies usually incur little or no liabilities and require only nominal capitalization because risk is limited. However, their commission income is often substantial and a steady source of funds for the parent company. Nevertheless, insurance ''underwriters'' typically have strong capital bases, good liquidity and profitable operations. Furthermore, their operating risks are generally stable and predictable.

Electronic data processing centers are often established under section 4(c)(8) of the Act, which permits them to sell their services to affiliated and unaffiliated customers. Section 4050.0 of this Manual cites examples of how an EDP servicer can have an unfavorable impact on the parent company or its affiliates. Management consulting firms and advisory companies usually require little capitalization and no funding and generate favorable earnings. Of the noncredit-extending subsidiaries, insurance underwriters and EDP servicers are generally the only companies requiring capital and funding in significant amounts.

However, all subsidiaries are subject to some level of risk, which could impact on the BHC. In the case of insurance underwriters, insurance benefits paid could exceed actuarial estimates. Such a situation, however rare, could necessitate financial support from the parent company. EDP servicers could, as a result of excessive computer down-time or equipment obsolescence, impact on consolidated earnings or require additional capital contributions. In addition, contingent liabilities, resulting from legal actions or failure to perform, could be a large multiple of a subsidiary's capital and may affect the parent.

4040.0.1 EARNINGS

In analyzing these subsidiaries, the examiner should consider the following:

1. Are any noncredit-extending subsidiaries operating at a loss or incurring low levels of earnings? If so, what is the cause and does it have a material impact on consolidated earnings?

2. Does the loss result in the subsidiary's reliance on the parent company or bank subsidiary(ies) for financial support? If so, in what form is the support provided?

3. If a loss has been incurred, has management initiated corrective measures? If not, why not?

4. Are the fees charged by the parent for services rendered limited to their *fair market value*? The answer to this question will almost always depend on information supplied by management. Management should be aware of the fair market rates charged by their competitors for similar services rendered.

5. Are the rates charged affiliates commensurate with the services provided and similar to rates charged nonaffiliated customers?

4040.0.2 RISK EXPOSURE

In noncredit-extending subsidiaries, risk exposure, of any meaningful magnitude, is often related to possible losses arising from legal actions for failure to perform services as contracted. The examiner should determine that the subsidiaries are being operated effectively by experienced and competent personnel under the direction of satisfactory management. The examiner should further determine that parent company management exercises appropriate controls over the activities of the subsidiary. Because of potential liability, the examiner should ascertain whether the subsidiaries have adequate insurance coverage (i.e., errors and omissions, public liability, etc.). The examiner should be alert to any contingent liabilities that would have a significant impact of the parent company. For example, the parent company might guarantee the payment of debt or leases for the subsidiary.

The internal services subsidiaries generally derive their business only from the parent company and its affiliates. Examples of such companies include forms printing firms, owners and operators of banking premises, and EDP servicing companies. Banking premises subsidiaries are established to hold or operate properties used wholly or substantially by the parent's subsidiary for its banking business. Generally, their operations do not impact unfavorably on the parent company. However, in instances where the banking premises are not wholly occupied by a banking subsidiary, the examiner should ascertain that the excess space is fully leased/rented. A high vacancy level could result in unprofitable operations or result in an abnormal rental charge to the banking subsidiary in order to operate the subsidiary on a profitable, or break even, basis.

EDP service centers provide bookkeeping or data processing services for the internal operations of the holding company and its subsidiaries, and store and process other banking, financial or related economic data. Generally, these service centers do not have a material effect on consolidated earnings performance as they provide essential services at costs comparable or below their independent counterparts. They usually operate on a break-even basis or at a nominal profit. However, there are some subsidiaries, including EDP servicers, which also provide services indirectly to unaffiliated concerns. EDP servicers operating under section 4(c)(1)(C) of the Act, may provide services to customers of its bank affiliates, provided that the service contract is between the bank and the customer. EDP servicers that operate as independent subsidiaries under section 4(c)(8) of the Act are not similarly restricted and are not considered "not for profit" organizations.

A financial analysis of a "not for profit" service subsidiary should concentrate on the organization's ability to control its expenses and its ability to provide its services to its affiliates at fair market value. Failure to control expenses may result in excessive charges to affiliates to the detriment of the affiliate.

For purposes of an analysis of earnings, analysts of bank holding companies have placed considerable weight on consolidated BHC financial data. Consolidated data, however, can be very misleading since bank assets and revenues are large in relation to their profit margins. On the other hand, the volume of nonbank assets is generally not nearly as large, but profit margins (or losses) tend to be much more substantial. The organizational structure of a holding company is of prime importance and must first be taken into consideration before attempting to analyze consolidated earnings. As an example, in the case of nonoperating shell bank holding companies with no nonbank subsidiaries, the earnings of the bank subsidiary should be nearly identical with consolidated earnings for the organization. Therefore, in these instances, the views and ratings of the applicable bank regulatory agency would normally be accepted and would apply to consolidated earnings of the BHC. This treatment would not apply to one-bank and multi-bank holding companies with substantial credit-extending nonbank subsidiaries. These holding companies require an in-depth analysis of earnings because of the adverse impact that a poorly operated subsidiary can have upon the consolidated earnings of the BHC.

In order to properly analyze consolidated earnings, it is best to review and study a consolidating statement of income and expense for the purpose of determining each entity's contribution to earnings. It is important to recognize that there need be no direct correlation between the asset size of a subsidiary and its relative contribution to total consolidated earnings. For example, a subsidiary accounting for a minute portion of consolidated assets could substantially negate satisfactory earnings of its larger asset base affiliates because of poor operations and sizeable losses.

When evaluating consolidated earnings, it is important to review the component parts of earnings for prior interim or fiscal periods for comparative purposes in order to determine trends. Considerable attention is to be focused on the various income and expense categories. The net interest income (difference between interest income and interest expense) of a company is highly revealing as it will give an indication of management's ability to borrow at attractive rates and employ those funds with maximum profitable results.

Items having a significant impact on earnings include the noncash charge, ''provisions for loan losses'' and the volume of nonaccrual and renegotiated or restructured credits. A large provision for loan losses is made necessary by poor quality assets which result in large charge-offs to valuation reserves. In order to replenish the reserve for loan losses to adequate levels to provide ample coverage against known and potential losses, large amounts of revenues must be ''set aside.'' Nonperforming and renegotiated credits either provide no income or provide a reduced rate of income to the extent that the assets are no longer profitable relative to the cost of funds and the cost of doing business. In situations where earnings are below average or unsatisfactory, a comment concerning the amount of provision for loan losses and volume of nonperforming loans is warranted in the financial analysis.

Other items of significance include taxes, particularly where tax credits are indicative of loss operations, and extraordinary or nonrecurring items. Extraordinary gains or losses are not the result of the normal operations of a company and should be analyzed independently from operating earnings. Generally, extraordinary items result from the sale of current or fixed assets. When significant amounts are involved, examiners should determine the underlying reasons behind such transactions.

After an analysis has been made of the pertinent components of earnings, analyze the ''bottom line'' or net income of the consolidated company. Generally, analysts relate net income to several benchmarks in order to evaluate performance. The ratios of earnings as a percentage of average equity capital or average assets are most widely used. Conclude the analysis with a comparison of a company's ratios in relation to its peer group.

Comparatively low earnings relative to its peer group may be a reflection of problems and weaknesses such as lax or speculative credit practices (resulting in nonearning assets or loan losses), high interest costs resulting from excessive debt, or rapid expansion into competitive industries subject to wide variations in income potential.

Earnings on a consolidated basis are the best measure of performance. Moreover, while the earnings of individual subsidiaries must not be ignored, the ability of holding company management to control the level of reported earnings in any one subsidiary reaffirms the practi-

cality of using the consolidated approach to analyze holding company profitability.

Essentially, the following points summarize areas which should be considered when analyzing consolidated earnings:

1. The return on consolidated assets and equity capital, as well as historical trends and peer group comparisons.

2. The ability of earnings to provide for capital growth, especially when taking into consideration recent and planned asset and deposit growth.

3. The ''quality'' of earnings is affected by the sufficiency of the provision to loan loss reserves and the asset quality of the organization. A high level of earnings that did not include sufficient provisions to the loan loss reserve during a period of high charge-offs may result in reductions in the reserve balance and thereby call to question the merits of high earnings in the face of declining reserve balances.

4. The ability of management to prepare realistic earnings projections in light of the risk structure and quality of assets.

The evaluation of asset quality based on classifications of ''substandard, doubtful and loss,'' is one of the most important elements to be taken into consideration when performing a financial analysis of a holding company because of the severe impact that poor quality assets can have on the overall condition of the organization. Procedures to measure asset quality of banks involve the use of the relationship of weighted classified assets to Tier 1 capital funds and total classifications to total capital funds. Accordingly, consolidated asset quality could be based on the relationship of aggregate weighted classified assets of the parent company, bank subsidiary(ies) and nonbank subsidiary(ies), to Tier 1 capital.

However, a problem encountered when viewing asset quality on a consolidated basis is the fact that in multi-bank holding companies there is usually a large timing difference between the dates of examinations of the banking subsidiaries. Therefore, the aggregating of classified bank assets from reports prepared at different times, reduces the currentness and validity of conclusions drawn. This problem can only be eliminated by using common examination and inspection dates which are not generally available.

Despite the shortcoming of using classification information from different dates, an examiner may determine that there is a sufficient measure of validity in using the data and may present an analysis based on consolidated weighted classifications. For example, if there are a small number of bank subsidiaries and if the examination dates are near a common point in time, timing differences may be inconsequential. Or, if a review of several years of a bank's examinations reveals a relatively constant or stable level of classifications, then the timing of the most recent examination would not invalidate use of the analytical tool. As such, the technique may be employed when circumstances permit.

Other factors to be considered in determining asset quality include the levels of nonaccrual and renegotiated loans, other real estate owned and past due loans. While these assets may not be subject to classification, they usually represent former or emerging problem loans. Moreover, in the aggregate, they may represent a significant proportion of the asset portfolio. If such is the case, they should be taken into consideration when the examiner determines his overall rating of asset quality.

It is difficult to rely on the adequacy of consolidated reserves because they are ''fractured'' and protect portfolios in different organizations and may not be interchangeable or transferable. The reserve of each entity in the corporate structure must be reviewed or analyzed individually. For example, if consolidated reserves appear inadequate, there is no consolidated reserve account per se that could be increased to adequate proportions. Consequently, the inadequacy would have to be identified at the parent or subsidiary level. Conversely, if consolidated reserves appear to adequately cover the aggregate of all ''loss'' and a certain portion of ''doubtful,'' it does not insure that all subsidiaries have adequate reserves. Nevertheless, despite the shortcomings of using consolidated reserves, the analyst should not hesitate to calculate and present a measure of the relationship of consolidated reserves to consolidated loans.

4060.3.1 INTRODUCTION TO EXAMINER GUIDELINES FOR RISK-BASED CAPITAL

To assist in assessing the capital adequacy of bank holding companies, the Board has established two measures of capital adequacy, the risk-based capital measure and the tier 1 leverage measure. The tier 1 leverage measure is discussed in section 4060.4.

4060.3.2 OVERVIEW OF RISK-BASED CAPITAL GUIDELINES

The Board's risk-based capital guidelines (guidelines) focus principally on the credit risks associated with the nature of banking organizations' on- and off-balance-sheet assets and on the type and quality of their capital. The information provided in this section should be utilized in conjunction with the risk-based capital guidelines in verifying the bank holding company's risk-based capital. Examiners must refer to Regulation Y (12 C.F.R. 225), appendix A, for a complete description of the risk-based capital adequacy guidelines for bank holding companies.

The guidelines do not incorporate other factors that may also affect the financial condition of banking organizations. These factors include overall interest-rate exposure; liquidity, funding, and market risks; the quality and level of earnings; the effectiveness of loan and investment policies on operational results and the quality of assets; and management's ability to monitor and control financial and operating risks.

The major objectives of the guidelines are to make regulatory capital requirements more sensitive to differences in credit-risk profiles among banking organizations; to factor off-balance-sheet exposures into the assessment of capital adequacy; to minimize disincentives to holding liquid, low-risk assets; and to achieve greater consistency in the evaluation of the capital adequacy of major banking organizations worldwide.

The guidelines set forth *minimum* supervisory capital standards for banking organizations. Therefore, banking organizations are expected to operate with capital levels above the minimum ratios. This is particularly true for banking organizations that are undertaking significant expansion or that are exposed to high or unusual levels of risk. The guidelines generally apply to those bank holding companies that have $150 million or more in assets on a consolidated basis.

At year-end 1992, the risk-based capital guidelines require banking organizations to meet a standard, a minimum ratio of total capital to risk-weighted assets of 8.0 percent and a minimum ratio of tier 1 capital to risk-weighted assets of 4.0 percent.

The risk-based capital guidelines are intended to better reflect the differences in credit-risk profiles among banking organizations and explicitly factor off-balance-sheet exposures into the assessment of capital adequacy by weighting on- and off-balance-sheet items by perceived degrees of credit risk. The basic elements of the framework include definitions of capital that include core elements and supplementary elements, assignment of on- and off-balance-sheet items to broad categories of credit risk, and the methodology for computing risk-based capital ratios for banking organizations on an interim and final basis.

In addition, examiners should be aware that when certain organizations that engage in trading activities calculate their risk-based capital ratio under appendix A, they must also refer to appendix E of that part, which incorporates capital charges for certain market risks into the risk-based capital ratio. Examiners should also refer to the *Trading Activities Manual* for more detailed supervisory guidance. When calculating their risk-based capital ratio under appendix A, such organizations are required to refer to appendix E for supplemental rules to determine qualifying and excess capital, calculate risk-weighted assets, calculate market-risk-equivalent assets, and calculate risk-based capital ratios adjusted for market risk.

4060.3.2.1 Definition of Capital

For the purposes of the risk-based capital guidelines, a banking organization's total capital will consist of two major components: ''core capital elements'' and ''supplementary capital elements.'' To qualify as an element of tier 1 or tier 2 capital, a capital instrument must be unsecured and may not contain or be covered by any covenants, terms, or restrictions that are

inconsistent with safe and sound banking practices.

4060.3.2.1.1 Tier 1 Capital

Tier 1 capital will consist of permanent core capital elements (common stockholders' equity, noncumulative perpetual preferred stock, a limited amount of cumulative perpetual preferred stock, and minority interest in the equity of consolidated subsidiaries) less goodwill and other intangible assets that are required to be deducted. Common stockholders' equity is limited to common stock; related surplus; and retained earnings, including capital reserves and adjustments for the cumulative effect of foreign-currency translation, net of any treasury stock; less net unrealized holding losses on available-for-sale equity securities with readily determinable fair values. For this purpose, net unrealized holding gains on such equity securities and net unrealized gains (losses) on available-for-sale debt securities are not included in common stockholders' equity.

4060.3.2.1.1.1 Common Stock Considerations

A capital instrument that is not permanent, or that has preference with regard to liquidation or the payment of dividends, is not deemed to be common stock, regardless of whether or not it is called common stock. Other preferences may also call into question whether the capital instrument is common stock. Close scrutiny should be paid to the terms of common stock issues that have issued more than one class of common stock. Preference features may be found in one of the classes and, if so, that class generally should not be treated as common stock.

From a supervisory standpoint, it is desirable that voting common stockholders' equity remain the dominant form of tier 1 capital. Accordingly, the risk-based capital guidelines state that bank holding companies should avoid overreliance on nonvoting equity elements in tier 1 capital. Nonvoting equity elements can arise in connection with common stockholders' equity in cases where a bank holding company has two classes of common stock, one voting and the other nonvoting. Alternatively, one class may have so-called super-voting rights entitling the holder to substantially more votes per share than the other class. In this case, the super-voting shares may have so many votes per share that the voting power of the other shares is effectively overwhelmed.

Although no formal limit is placed on the amount of noncumulative perpetual preferred stock that may be included in tier 1 capital, the guidelines state that bank holding companies should avoid overreliance on preferred stock and other nonvoting equity elements in tier 1 capital.[1] Bank holding companies that have nonvoting, or effectively nonvoting, common equity and tier 1 perpetual preferred stock in excess of their voting common stock are clearly overrelying on nonvoting equity elements in tier 1 capital. In such cases, it may be appropriate to reallocate some of the nonvoting equity elements from tier 1 capital to tier 2 capital.

4060.3.2.1.1.2 Perpetual Preferred Stock Considerations

Traditional convertible perpetual preferred stock, which the holder can convert into a fixed number of common shares at a preset price, ordinarily does not raise supervisory concerns and therefore generally qualifies as tier 1 capital. However, forms of preferred stock for which the holder must or can convert common stock at the market price prevailing at the time of conversion do raise supervisory concerns. Such preferred stock may be converted into an increasing number of common shares as the banking organization's condition deteriorates, for example, as the market price of the common stock falls. The potential conversion of such preferred stock into common stock could pose a threat of dilution to the existing common shareholders. The threat of dilution could make the issuer reluctant to sell new common stock or place the issuer under strong market pressure to redeem or repurchase the convertible preferred. Such convertible preferred stock generally should be excluded from tier 1 capital.

Perpetual preferred stock issues may include other provisions or pricing mechanisms that would provide significant incentives or pressures for the issuer to redeem the stock for cash, especially at a time when the issuer is in a weakened financial condition. As a general matter, an issue that contains such features would be ineligible for tier 1 treatment.

1. A noncumulative issue may not permit the accruing or payment of unpaid dividends in any form, including the form of dividends payable in common stock. Perpetual preferred stock that calls for the accumulation and future payment of unpaid dividends is deemed to be cumulative, regardless of whether it is called noncumulative, and is generally includable in tier 2 capital.

4060.3.2.1.1.3 Considerations Regarding Minority Interest in Equity Accounts of Consolidated Subsidiaries

Minority interest in equity accounts of consolidated subsidiaries is included in tier 1 capital because, as a general rule, it represents equity that is freely available to absorb losses in operating subsidiaries. Banking organizations are expected to avoid using minority interest as an avenue for introducing elements that do not otherwise qualify as tier 1 capital (such as cumulative or auction-rate perpetual preferred stock) or that would, in effect, result in an excessive reliance on preferred stock within tier 1 capital. If a banking organization uses its minority interest in these ways, supervisory concerns may warrant reallocating some of the minority interest in equity accounts of consolidated subsidiaries from tier 1 to tier 2 capital.

Whenever a banking organization has included perpetual preferred stock of an operating subsidiary in minority interest, a possibility exists that such capital has been issued in excess of the subsidiary's needs for the purpose of raising cheaper capital. Stock issued under these circumstances may, in substance if not in legal form, be secured by the subsidiary's assets. Should the subsidiary fail, the outside preferred investors would have a claim on the subsidiary's assets that is senior to the claim that the banking organization, as a common shareholder, has on those assets. Therefore, as a general rule, issuances in excess of a subsidiary's needs do not qualify for inclusion in capital. The possibility that a secured arrangement exists should be considered if the subsidiary lends significant amounts of funds to the parent banking organization, is unusually well capitalized, has cash flow in excess of its operating needs, holds a significant amount of assets with minimal credit risk (for example, U.S. Treasury securities) that are not consistent with the subsidiary's operations, or has issued preferred stock at a significantly lower rate than the parent could obtain for a direct issue.

Some bank holding companies may use a nonoperating subsidiary or special-purpose entity (SPE) to issue perpetual preferred stock to outside investors. Such a subsidiary may be set up offshore so that it can receive favorable tax treatment for the dividends paid on the stock. In such arrangements, a strong presumption exists that the stock is, in effect, secured by the assets of the subsidiary. It has been agreed upon internationally that a banking organization may not include in its tier 1 capital minority interest in the perpetual preferred stock of nonoperating subsidiaries. Furthermore, such minority interest may not be included in tier 2 capital unless it can conclusively be proven that the stock is unsecured. Even if the banking organization's accountants have permitted it to account for perpetual preferred stock issued through an SPE as stock of the banking organization, rather than as minority interest in the equity accounts of a consolidated subsidiary, the stock may not be included in tier 1 capital and most likely is not includable in tier 2 capital.

Banking organizations may also use operating or nonoperating subsidiaries to issue subordinated debt. As with perpetual preferred stock issued through such subsidiaries, it is possible that such debt is in effect secured and therefore not includable in capital.

4060.3.2.1.1.4 Certain Tier 1 Cumulative Preferred Stock

On October 21, 1996, the Board approved the use of certain cumulative preferred stock instruments in tier 1 capital for bank holding companies. These instruments, which are marketed under a variety of proprietary names, such as MIPS and TOPRS, are issued out of a special-purpose subsidiary that is wholly owned by the parent company. The proceeds are lent to the parent in the form of a very long-term, deeply subordinated note.

Bank holding companies seeking to issue such securities should consult with their District Federal Reserve Bank. Such arrangements, which give rise to minority interest upon consolidation of the subsidiary with the parent holding company, normally will be accorded tier 1 capital status.

To be eligible as tier 1 capital, such instruments must provide for a minimum five-year consecutive deferral period on distributions to preferred shareholders. In addition, the intercompany loan must be subordinated to all subordinated debt and have the longest feasible maturity.

The amount of these instruments, together with other cumulative preferred stock a bank holding company may include in tier 1 capital, is limited to 25 percent of tier 1 capital. Like other preferred stock includable in capital, these

instruments require Federal Reserve approval before they may be redeemed.

4060.3.2.1.2 Tier 2 Capital

Tier 2 capital consists of (1) a limited amount of the allowance for loan and lease losses;[2] (2) cumulative perpetual preferred stock (original term of 20 years or more) including related surplus (also includes cumulative perpetual preferred stock exceeding its tier 1 limitation, including auction-rate preferred stock, or any other perpetual preferred stock in which the dividend rate is reset periodically, in whole or in part, based on the holding company's financial condition); (3) hybrid capital instruments, perpetual debt, mandatory convertible debt securities; (4) limited amounts (50 percent of tier 1 capital) of term subordinated debt, intermediate-term preferred stock, and unsecured long-term debt issued before March 12, 1988, that qualified as secondary capital when issued; and (5) limited unrealized holding gains on equity securities. Tier 2 capital may not exceed tier 1 capital (net of goodwill and other intangible assets required to be deducted in accordance with section II.B.1.b. of the risk-based measure of the capital adequacy guidelines).

The amount of mandatory convertible securities that have the proceeds of common or perpetual preferred stock dedicated to retire or redeem them, and a maximum maturity of 12 years, should be treated as term subordinated debt. Mandatory convertible securities, net of the stock dedicated to redeem or retire the issues, are included within tier 2 on an unlimited basis.

There is a limit on the amount of unrealized holding gains on equity securities and the unrealized gains (losses) on other assets. Up to 45 percent of pretax net unrealized holding gains (that is, the excess, if any, of the fair value over historical cost) on available-for-sale equity securities, with readily determinable fair values, may be included in supplementary capital. However, the Federal Reserve may exclude all or a portion of these unrealized gains from tier 2 capital if the Federal Reserve determines that the equity securities are not prudently valued. Unrealized gains (losses) on other types of assets, such as bank premises and available-for-sale debt securities, are not included in supplementary capital. The Federal Reserve may take these unrealized gains (losses) into account as additional factors when assessing an institution's overall capital adequacy.

4060.3.2.1.3 Deductions from Tier 1 and Tier 2 Capital

The risk-based capital guidelines require that 50 percent of the aggregate amount of capital investments in unconsolidated banking and finance subsidiaries should be deducted from the bank holding company's tier 1 capital and 50 percent from its tier 2 capital. If the amount of tier 2 capital is insufficient for the required deduction, the additional amount needed would be deducted from tier 1 capital. Reciprocal holdings of other banking organizations' capital instruments are to be deducted from the sum of tier 1 and tier 2 capital.

4060.3.2.2 Risk-Weighting of On- and Off-Balance-Sheet Items

The risk-based capital guidelines establish four general categories of credit risk. These categories of credit risk reflect the nature and quality of collateral, guarantees, and organizations issuing or backing obligations. Assets and credit-equivalent amounts of off-balance-sheet items are allocated to the various categories, which are assigned weights of zero percent, 20 percent, 50 percent, and 100 percent depending on the perceived level of credit risk to the banking organization. The majority of on-balance-sheet items will fall in the 100 percent category. The appropriate dollar value of the amount in each category is multiplied by the risk weight associated with that category. The resulting weighted values for each of the risk categories are added together.

Off-balance-sheet items are incorporated into the risk-based capital ratio through a two-step process. First, a credit-equivalent amount[3] for the item is calculated by multiplying the item by a credit-conversion factor. Second, the credit-equivalent amount of the off-balance-sheet item

2. At year-end 1992, this allowance is limited to 1.25 percent of risk-weighted assets.

3. For interest-rate and foreign-exchange contracts, the credit-equivalent amount is determined by multiplying the notional amount by a conversion factor (which is different for contracts maturing in one year or less and those maturing in over a year) and adding the resulting amount to the positive mark-to-market values of the contracts. The maximum risk weight applied to interest-rate and exchange-rate contracts is 50 percent.

is then categorized in the same manner as on-balance-sheet items, that is, by credit risk. The credit-conversion factors, that is, factors ranging from zero to 100 percent,[4] are intended to reflect the risk characteristics of the activity in terms of an on-balance-sheet equivalent. Once the credit-equivalent amount of the off-balance-sheet item is calculated, that amount is then categorized in the same manner as on-balance-sheet items, that is, by credit risk. The resulting sum of the risk-adjusted on- and off-balance-sheet items is the bank holding company's total risk-weighted assets, which comprises the denominator of the risk-based capital ratio.

Generally, if an item may be assigned to more than one risk category, that item should be assigned to the category that has the lowest risk weight. An exception to this general rule exists for an investment in shares of a fund that invests in various securities or money market instruments that are eligible to be assigned to different risk categories. In this case, the total investment would generally be assigned to the risk category appropriate to the highest risk-weighted asset the fund may hold in accordance with the stated limits set forth in the prospectus. Bank holding companies have the option of assigning the investment on a pro rata basis to different risk categories according to the investment limits in the fund's prospectus. Regardless of the risk-weighting method used, the total risk weight of a mutual fund must be no less than 20 percent. If the bank holding company chooses to assign a fund investment on a pro rata basis, and the sum of the investment limits for all asset categories as described in the fund's prospectus exceeds 100 percent, it must assign risk weights *based on the assumption that the fund invests the largest possible percentage of its assets in the highest risk-weighted categories.*[4a] If, in order to maintain a necessary degree of short-term liquidity, a fund is permitted to hold an insignificant amount of its assets in short-term, highly liquid securities of superior credit quality that do not qualify for a preferential risk weight, then those securities may be disregarded in determining the fund's risk weight.

The prudent use of hedging instruments by a fund to reduce the risk of its assets will not increase the risk weighting of the fund investment. For example, the use of hedging instruments by a fund to reduce the interest-rate risk of its government bond portfolio will not increase the risk weight of that fund above the 20 percent category. Nonetheless, if a fund engages in any activities that appear speculative in nature or the fund has any other characteristics that are inconsistent with the preferential risk weighting assigned to the fund's assets, holdings in the fund will be assigned to the 100 percent risk category.

Under the guidelines, the primary determinant of the risk category of a particular on- or off-balance-sheet item is the obligor. To a limited extent, collateral or guarantees securing some obligations may be used to place an item or items in lower risk weights than would be available to the obligor.

The forms of collateral that are available for this purpose are cash on deposit in subsidiary lending institutions;[5] securities issued or guaranteed by the central governments of the OECD-based group of countries, U.S. government agencies, or U.S. government–sponsored agencies; and securities issued by multilateral lending institutions or regional development banks. Obligations that are fully secured by such collateral are assigned to the 20 percent risk category.

In order for a claim to be considered collateralized for risk-based capital purposes, the underlying arrangements must provide that the claim will be secured by recognized collateral throughout its term. A commitment may be considered collateralized for risk-based capital purposes to the extent that its terms provide that advances made under the commitment will be secured throughout their term.

The market value of eligible securities used as collateral should be used to determine whether an obligation is partially or fully secured. For partially secured obligations, the secured por-

4. Interest-rate and exchange-rate contracts use conversion factors significantly below those used for other off-balance-sheet activities. These factors are assigned by remaining maturity, one year or less or more than one year, and range from 0 to 5 percent.

4a. For example, assume that a fund's prospectus permits up to 30 percent of the fund's assets to be invested in 100 percent risk-weighted assets, up to 40 percent of the fund's assets to be invested in 50 percent risk-weighted assets, and up to 60 percent of the fund's assets to be invested in 20 percent risk-weighted assets. In such a case, the bank holding company must assign 30 percent of the total investment to the 100 percent risk category, 40 percent to the 50 percent risk category, and 30 percent to the 20 percent risk category. It may not minimize its capital requirement by assigning 60 percent of the total investment to the 20 percent risk category and 40 percent to the 50 percent risk category.

5. With regard to syndicated credits secured by cash on deposit in the lead institution, there is a limited exception to the rule that cash must be on deposit in the lending institution to be recognized as collateral. A lending institution participating in the syndication may treat its pro rata share of the credit as collateralized if it has a perfected interest in its pro rata share of the collateral.

tion is assigned a 20 percent risk weight. Any unsecured portion is assigned the risk weight appropriate for the obligor or guarantor, if any. The extent to which an off-balance-sheet item is secured by collateral is determined by the degree to which the collateral covers the face amount of the item before it is converted to a credit-equivalent amount and assigned to a risk category.

Certain guarantees are recognized for risk-based capital purposes as follows: guarantees of the OECD and non-OECD central governments; U.S. government agencies and U.S. government–sponsored agencies; state and local governments of the OECD-based group of countries; multilateral lending institutions and regional development banks; and U.S. depository institutions and foreign banks. If an obligation is partially guaranteed, the portion that is not fully covered is assigned the risk weight appropriate for the obligor or collateral, if any. An obligation that is covered by two types of guarantees having different risk weights is apportioned between the two risk categories appropriate for the guarantors.

4060.3.3 IMPLEMENTATION

The guidelines apply to those bank holding companies having $150 million or more in assets on a consolidated basis. For bank holding companies having *less than* $150 million in assets on a consolidated basis, the guidelines will apply only to their subsidiary banks unless (1) the parent bank holding company is engaged in nonbank activity involving significant leverage (including off-balance-sheet activity) or (2) the parent holding company has a significant amount of outstanding debt that is held by the general public.

Banking organizations are expected to meet the minimum risk-based capital ratio by year-end 1992. The minimum ratio of capital to risk-weighted assets should be 8 percent or more with at least 4 percent taking the form of tier 1 capital. An assessment of the banking organization's capital adequacy should reflect the level and severity of the classified assets summarized in the examination and inspection.

Banking organizations that do not meet the minimum risk-based capital ratios, or that are considered to lack sufficient capital to support their activities, are expected to develop and implement capital plans acceptable to the Federal Reserve for achieving adequate levels of capital that will satisfy the provisions of the guidelines or with agreed-upon arrangements established for designated banking organizations. In addition, such banking organizations should avoid any actions, including increased risk-taking or unwarranted expansion, that would lower or further erode their capital positions. In these cases, examiners are to review and comment on banking organizations' capital plans and their progress in meeting minimum risk-based capital requirements.

It would be appropriate to include comments on risk-based capital in the open section of the examination/inspection report when assessing the organization's capital adequacy. Banking organizations should be encouraged to establish as soon as possible capital levels and ratios that are consistent with the organization's overall financial profiles. Examiner comments should address the adequacy of the banking organization's plans and progress toward meeting and maintaining the minimum capital ratios, according to the guidelines.

4060.3.4 DOCUMENTATION

Banking organizations are expected to have adequate systems in place to compute their risk-based capital ratios. Such systems should be sufficient to document the composition of the ratios for regulatory reporting and other supervisory purposes. Generally, supporting documentation will be expected to establish how banking organizations track and report their capital components and on- and off-balance-sheet items that are given preferential treatment. It may be necessary for examiners to reassign on- or off-balance-sheet items that are given a preferential risk weight to a weight of 100 percent, when supporting documentation is inadequate.

Examiners are expected to verify that bank holding companies are correctly reporting the information requested on the holding companies' consolidated financial statements (FR Y-9C), which are used to compute the organization's risk-based capital ratios.

4060.3.5 SELECTED SUPERVISORY CONSIDERATIONS FOR CALCULATING AND EVALUATING RISK-BASED CAPITAL

Examiners must consider certain requirements

and factors when assessing the risk-based capital ratios and the overall capital adequacy of banking organizations. Analysis of these requirements and factors may have a material impact on the amount of capital banking organizations must hold to appropriately support certain activities for on- and off-balance-sheet items. The treatment of the following activities must be considered when assessing compliance with the guidelines and overall capital adequacy of banking organizations.

- *Certain capital-adjustment considerations:*
  - — investments and advances to unconsolidated banking and finance subsidiaries
  - — review and monitoring of intangible assets
  - — reciprocal holdings of banking organizations' capital instruments
- *Certain balance-sheet activity considerations:*
  - — investment in shares of a mutual fund
  - — mortgage-backed securities
  - — loans secured by first liens on one- to four-family residential properties
- *Certain off-balance-sheet activity considerations:*
  - — securities lent
  - — unused commitments
  - — financial and performance standby letters of credit
  - — avoidance of double-counting of interest-rate and exchange-rate contracts
  - — treatment of commodity and equity swaps

  - — netting of swaps and similar contracts
  - — assets sold with recourse
- *Considerations in the overall assessment of capital adequacy:*
  - — unrealized asset values
  - — terms of subordinated debt and intermediate-term preferred stock
  - — ineligible collateral and guarantees
  - — overall asset quality
  - — interest-only and principal-only strips
  - — interest-rate risk
  - — claims on, and claims guaranteed by, OECD central governments

4060.3.5.1 Investments in and Advances to Unconsolidated Banking and Finance Subsidiaries and Other Subsidiaries

Generally, debt and equity capital investments and any other instruments deemed to be capital in unconsolidated banking and finance subsidiaries[6] are to be deducted from the consolidated capital of the banking organizations, regardless of whether the investment is made by a parent bank holding company or its direct or indirect subsidiaries.[7] Fifty percent of the investment is to be deducted from tier 1 capital and 50 percent from tier 2 capital. In cases where tier 2 capital is not sufficient to absorb the portion (50 percent) of the investment allocated to it, the remainder (up to 100 percent) is to be deducted from tier 1 capital. In addition, capital investments in certain other subsidiaries that, while consolidated for accounting purposes, are not consolidated for certain supervisory or regulatory purposes, such as to facilitate functional regulation, are to be deducted from tier 1 and tier 2 capital of the banking organization in the same proportion as for unconsolidated banking and finance subsidiaries.

Advances to banking and finance subsidiaries (that is, loans, extensions of credit, guarantees, commitments, or any other credit exposures) not considered as capital are included in risk assets at the 100 percent risk weight (unless recognized collateral or guarantees dictate weighting at a lower percentage). However, such advances may be deducted from the parent banking organization's consolidated capital if examiners find that the risks associated with the advances are similar to the risks associated with capital investments, or if such advances possess risk factors that warrant an adjustment to capital for supervisory purposes. These risk factors could include the absence of collateral support or the clear intention of banking organizations to allow the advances, regardless of form, to serve as capital to subsidiaries.

The Board does not automatically deduct investments in other unconsolidated subsidiaries or investments in joint ventures and associated companies. Nonetheless, resources invested in these entities support assets that are not consolidated with the rest of the bank holding company and, therefore, may not be generally available to support additional leverage or absorb losses of affiliated institutions. Moreover, experience has shown that banking organizations often stand behind the losses of affiliated institutions in order to protect the reputation of the organization as a whole. In some cases, this has led to losses that have exceeded the investments in these entities.

Accordingly, the level and nature of such investments should be closely monitored. For risk-based capital purposes, on a case-by-case basis, a bank holding company may be required to deduct such investments from total capital, to apply an appropriate risk-weighted capital charge against its pro rata share of the assets of the affiliated entity, to perform a required line-by-line consolidation of the entity, or to operate with a risk-based capital ratio above the minimum. In determining the appropriate capital treatment for such actions, the Board will generally take into account whether (1) the banking organization has significant influence over the financial or managerial policies or operations of the affiliated entity, (2) the banking organization is the largest investor in the entity, or (3) other circumstances prevail (such as the existence of significant guarantees from the bank holding company) that appear to closely tie the activities of the affiliated company to the banking organization.

4060.3.5.1.1 Review and Monitoring of Intangible Assets

For bank holding companies, tier 1 capital is generally defined as the sum of core capital

6. A banking and finance subsidiary generally is defined as any company engaged in banking or finance in which the parent institution directly or indirectly holds more than 50 percent of the outstanding voting stock, or which is otherwise controlled or capable of being controlled by the parent organization.

7. An exception to this deduction is to be made in the case of shares acquired in the regular course of securing or collecting a debt previously contracted in good faith.

elements less goodwill and other intangible assets required to be deducted in accordance with section II.B.1.b. of the risk-based measure of the capital adequacy guidelines for BHCs. Certain intangible assets *are not required to be deducted* from capital.

4060.3.5.1.1.1 Certain Intangible Assets That May Be Included in Capital

All servicing assets, including servicing assets on assets other than mortgages (that is, nonmortgage-servicing assets), are deemed identifiable intangible assets. The only types of identifiable intangible assets that may be included in, that is, not deducted from, an organization's capital are readily marketable mortgage-servicing assets, nonmortgage-servicing assets, and purchased credit-card relationships (PCCRs). The total amount of these assets that are included in capital, in the aggregate, cannot exceed 100 percent of tier 1 capital. Nonmortgage-servicing assets and purchased credit-card relationships are subject to a separate sublimit of 25 percent of tier 1 capital.[8]

Purchased mortgage-servicing assets are identifiable intangible assets associated with the right to service mortgage loans. They usually arise when the rights are purchased from the entity that originated the mortgage loans. An organization that acquires purchased mortgage-servicing assets (PMSAs) has the obligation to collect principal and interest payments and escrow accounts from the mortgagor and to ensure that all amounts collected from the mortgagor are passed on to the appropriate parties. For performing these services, the servicer receives a fee, which is generally based on the remaining principal amount due on the mortgages being serviced.

Originated mortgage-servicing assets (OMSAs) generally represent the servicing rights acquired when an organization originates mortgage loans and subsequently sells the loans but retains the servicing rights. OMSAs are capitalized as balance-sheet assets in the same manner as PMSAs as a result of a June 1996 Financial Accounting Standards Board decision (FAS 125), "Accounting for the Transfers and Servicing of Financial Assets and Extinguishments of Liabilities." FAS 125 requires the right to service mortgage loans for others to be separately recognized as a servicing asset or liability, however the rights were acquired. Servicing becomes a distinct asset or liability only when it is contractually separated from the underlying assets by sale or securitization of the assets with servicing retained or by separate purchase or assumption of the servicing. See section 3070.0.6 for information on, and accounting for, mortgage-servicing assets.

Purchased credit-card relationships are identifiable intangible assets associated with the right to provide future advances and other services to credit card holders and to provide correspondent-merchant processing under credit card arrangements that have been originated by, and purchased from, another entity. PCCRs usually arise when a credit card portfolio is bought, and the purchaser acquires the current advances outstanding under the credit card arrangements, which are tangible assets, as well as the right to provide future services to the cardholders, which is an intangible asset. The value of PCCRs is derived from the anticipated profit the purchaser will earn from interest on future advances and from fees charged for other future credit card–related services, after covering expenses and other operating costs such as credit losses.

When calculating the limitations on mortgage-servicing assets, nonmortgage-servicing assets, and purchased credit-card relationships, the definition of tier 1 capital will be the sum of core capital elements, net of goodwill and net of all identifiable intangible assets and similar assets other than mortgage-servicing assets, nonmortgage-servicing assets, and purchased credit-card relationships, regardless of when they were acquired, but prior to the deduction of deferred-tax assets.

Bank holding companies must review the book value of all intangible assets at least quarterly and make adjustments to these values as necessary. The fair market values of all intangible assets, nonmortgage-servicing assets, and purchased credit-card relationships also must be determined at least quarterly. This determination is to include adjustments for any significant changes made to the original valuation assumptions, including changes in prepayment estimates or account-attrition rates.

8. Amounts of mortgage-servicing rights and purchased credit-card relationships in excess of these limitations, as well as all other identifiable intangible assets, including core deposit intangibles and favorable leaseholds, are to be deducted from an organization's core capital elements in determining tier 1 capital. Identifiable intangible assets, however, exclusive of mortgage-servicing assets and purchased credit-card relationships, acquired on or before February 19, 1992, generally *will not* be deducted from capital for supervisory purposes. They will, however, continue to be deducted for applications purposes.

Examiners will review both the book value and the fair market value assigned to these assets, together with supporting documentation, during the inspection process. In addition, the Federal Reserve may require, on a case-by-case basis, an independent valuation of a BHC's intangible assets.

The amount of mortgage-servicing rights, nonmortgage-servicing assets, and purchased credit-card relationships that a bank holding company may include in capital is limited to the lesser of 90 percent of their fair market value (as determined according to the guidance herein), or 100 percent of their book value (on a GAAP basis), as adjusted for capital purposes in accordance with the instructions to the Consolidated Financial Statements for Bank Holding Companies (FR Y-9C Report). If both the application of the limits on mortgage-servicing assets, nonmortgage-servicing assets, and purchased credit-card relationships and the adjustment of the balance-sheet amount for these intangibles would result in an amount being deducted from capital, the BHC would deduct only the greater of the two amounts from its core capital elements in determining tier 1 capital.

Bank holding companies may elect to deduct disallowed servicing assets on a basis that is net of any associated deferred-tax liability. Deferred-tax liabilities netted in this manner cannot also be netted against deferred-tax assets when determining the amount of deferred-tax assets that are dependent upon future taxable income.

The treatment of identifiable intangible assets discussed above generally will be used in the calculation of a bank holding company's capital ratios for supervisory and applications purposes. In making an overall assessment of an organization's capital adequacy for applications purposes, however, the Board, if it deems appropriate, may take into account the quality and composition of an organization's capital, together with the quality and value of its tangible and intangible assets.

4060.3.5.1.1.2 Examiners' Review of Intangibles

During on-site examinations and inspections, examiners are to review the evidence of title to and the accounting for intangible assets, including their respective amortization schedules and supporting documentation. Carrying values of intangible assets and fair market values assigned to these assets that are overstated or not adequately supported with documentation on how the carrying values were originated, amortized, or adjusted should be excluded from banking organizations' risk-based capital calculations. Intangible assets in excess of 25 percent of tier 1 capital should be closely scrutinized along with any unusual items and, if supervisory concerns warrant, deducted from tier 1 capital. An arrangement whereby a bank holding company enters into a licensing or leasing agreement or similar transaction to avoid booking an intangible asset should be subject to particularly close scrutiny. Normally, such arrangements will be dealt with by adjusting the bank holding company's capital calculation in an appropriate manner. In making their evaluation of intangible assets, examiners are to consider a number of factors, including—

1. the reliability and predictability of any cash flows associated with the asset and the degree of certainty that can be achieved in periodically determining the asset's useful life and value,
2. the existence of an active and liquid market for the asset, and
3. the feasibility of selling the asset apart from the banking organization or from the bulk of its assets.

Intangible rights that have been allowed to lapse or that are no longer used should be recommended for authorized write-off. Examiners should review intangible assets, such as mortgage-servicing rights, nonmortgage-servicing rights (for example, core deposit intangibles and leaseholds), and purchased credit-card relationships, and determine that the organization properly monitors their level and quality.

Consistent with long-standing Board policy, banking organizations experiencing substantial growth, whether internally or by acquisition, are expected to maintain strong capital positions substantially above minimum supervisory levels, without significant reliance on intangible assets.

4060.3.5.1.2 Reciprocal Holdings of Banking Organizations' Capital Instruments

Reciprocal holdings (intentional cross-holdings) of banking organizations' capital instruments are to be deducted from the total capital of an organization for the purpose of determining the total risk-based capital ratio. Reciprocal holdings are cross-holdings resulting from formal or

informal arrangements between banking organizations to swap or exchange each other's capital instruments. Deductions of holdings of capital securities also would not be made in the case of interstate ''stake-out'' investments that comply with the Board's policy statement on nonvoting equity investments (12 C.F.R. 225.143). In addition, holdings of capital instruments issued by other banking organizations but taken in satisfaction of debts previously contracted would be exempt from any deduction from capital.

4060.3.5.1.3 Deferred-Tax Assets

The amount of deferred-tax assets that are dependent on future taxable income, net of the valuation allowance for deferred-tax assets, that may be included in, that is, not deducted from, a banking organization's capital may not exceed the lesser of—

1. the amount of these deferred-tax assets that the banking organization is expected to realize within one year of the calendar quarter–end, based on the projections of future taxable income for that year,[9] or
2. 10 percent of tier 1 capital. The reported amount of deferred-tax assets, net of any valuation allowance for deferred-tax assets, in excess of the lesser of these two amounts is to be deducted from a banking organization's core capital elements in determining tier 1 capital.

For purposes of calculating this 10 percent limitation, tier 1 capital is defined as the sum of the core capital elements, net of goodwill, and net of all identifiable intangible assets other than mortgage-servicing assets, nonmortgage-servicing assets, and purchased credit-card relationships, before any disallowed deferred-tax assets are deducted. There generally is no limit in tier 1 capital on the amount of deferred-tax assets that can be realized from taxes paid in prior carry-back years and from future reversals of existing taxable temporary differences.

4060.3.5.1.4 Revaluation Reserves

These reserves reflect the formal balance-sheet restatement or revaluation for capital purposes of asset carrying values to reflect the current market values. The Federal Reserve generally has not included unrealized asset appreciation in capital-ratio calculations, although it has long taken such values into account as a separate factor in assessing the overall financial strength of a banking organization.

Consistent with long-standing supervisory practice, the excess of market values over book values for assets held by bank holding companies will generally not be recognized in supplementary capital or in the calculation of the risk-based capital ratio. However, all bank holding companies are encouraged to disclose their equivalent of premises (building) and security-revaluation reserves. The Federal Reserve will consider any appreciation, as well as any depreciation, in specific asset values as additional considerations in assessing overall capital strength and financial condition.

4060.3.5.2 Certain Balance-Sheet Activity Considerations

4060.3.5.2.1 Investment in Shares of a Mutual Fund

Under the guidelines, the general rule applied when weighting the full amount of an item that qualifies for placement in more than one category—for example, a state revenue bond (50 percent) collateralized by U.S. Treasury securities (20 percent)—is that the asset is assigned to the lowest risk weight. An exception to this general rule is made for an investment in shares of mutual funds when the portfolio consists of various securities and money market instruments that could be assigned to different categories. Such investments in shares of mutual funds are assigned to the risk category appropriate to the *highest* weighted security or instrument that the fund is permitted to hold in accordance with its stated investment objectives. In no case are investments in shares of funds

9. To determine the amount of expected deferred-tax assets realizable in the next 12 months, a banking organization should assume that all existing temporary differences fully reverse as of the report date. Projected future taxable income should not include net operating loss carry-forwards to be used during that year or the amount of existing temporary differences a bank holding company expects to reverse within the year. Such projections should include the estimated effect of tax-planning strategies that the organization expects to implement to realize net operating loss or tax credit carry-forwards that will otherwise expire during the year. A new 12-month projection does not have to be prepared each quarter. On interim report dates, banking organizations may use the future taxable income projections for their current fiscal year, adjusted for any significant changes that have occurred or are expected to occur.

assigned to the zero risk category. For example, if a fund consists of U.S. Treasuries and commercial paper, the entire investment would be risk-weighted at 100 percent. However, if a fund is permitted to hold for short-term liquidity purposes insignificant amounts of its assets in short-term, highly liquid securities that would be weighted at 100 percent, such securities are not to be considered when determining the appropriate risk category into which the banking organization's holdings in the overall investment funds should be assigned. Regardless of the composition of the funds' securities, if the fund engages in any activities that *appear speculative* or have other characteristics that are inconsistent with the preferential risk weighting assigned to the fund's investments, holdings in the fund will be assigned to the 100 percent risk weight. Examiners are to review the holdings of investments in funds that are assigned to a risk category less than 100 percent to determine that the preferential weighting is appropriate.

4060.3.5.2.2 Mortgage-Backed Securities

Mortgage-backed securities (including pass-throughs and collateralized mortgage obligations, but not stripped securities) that are *issued or guaranteed* by a U.S. government agency or U.S. government–sponsored agency are assigned to the risk-weight category appropriate to the issuer or guarantor.

For risk-based capital purposes, mortgage-backed securities (MBSs), including pass-throughs, collateralized mortgage obligations (CMOs), and real estate mortgage investment conduits (REMICs), fall into one of the following categories:

4060.3.5.2.2.1 MBSs Issued or Guaranteed by a U.S. Government Agency or U.S. Government–Sponsored Agency

U.S. government agency MBSs, that is, Government National Mortgage Association (GNMA or Ginnie Mae) securities, generally are assigned a zero percent risk weight. U.S. government–sponsored agency MBSs, that is, Federal National Mortgage Association (FNMA or Fannie Mae) and Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac) securities, generally are assigned a 20 percent risk weight.

4060.3.5.2.2.2 Privately Issued MBSs Meeting Certain Criteria

The holdings of privately issued mortgage-backed securities are to be treated as indirect holdings of the underlying assets and weighted the same as the underlying assets. Privately issued mortgage-backed securities are included in the 50 percent risk-weight category provided that—

1. the structure of the security meets the criteria as set forth in section III.B.3. of the guidelines (and as discussed below);
2. if the security is backed by a pool of conventional mortgages, on one- to four-family residential or multifamily residential properties, *each* underlying mortgage meets the criteria described in section III.B.3. of the guidelines for eligibility for the 50 percent risk category at the time the pool is originated;
3. if the security is backed by privately issued mortgage-backed securities, *each* underlying security qualifies for the 50 percent risk category; and
4. if the security is backed by a pool of multifamily residential mortgages, principal and interest payments on the security are not 30 days or more past due.

Privately issued mortgage-backed securities that do not meet these criteria or that do not qualify for a lower risk weight are generally assigned to the 100 percent risk category. When mortgage-backed securities have underlying assets composed of more than one type of asset that could be assigned to different risk cate-

gories, the entire mortgage-backed security is assigned to the highest risk-weight category, but in no case to a zero risk-weight category.

Examiners are to review holdings of privately issued mortgage-backed securities that are assigned a 50 percent risk weight to ensure that they meet the specified criteria.

Privately issued mortgage-backed securities, including pass-throughs and collateralized mortgage obligations, may be treated as indirect holdings of the underlying assets, provided that—

1. the underlying assets are held by an independent trustee and the trustee has a first-priority, perfected security interest in the underlying assets on behalf of the holders of the security;
2. either the holder of the security has an undivided pro rata ownership interest in the underlying mortgage assets, or the trust or single-purpose entity (or conduit) that issues the security has no liabilities unrelated to the issued securities;
3. the security is structured such that the cash flow from the underlying assets in all cases fully meets the cash-flow requirements of the security without undue reliance on any reinvestment income; and
4. there is no material reinvestment risk associated with any funds awaiting distribution to the holders of the security.

4060.3.5.2.2.3 Stripped Mortgage-Backed Securities

All stripped mortgage-backed securities, including interest-only strips (IOs), principal-only strips (POs), and similar instruments, and any class of mortgage-backed securities that can absorb more than its pro rata share of loss without the whole issue being in default, are assigned to the 100 percent risk-weight category, regardless of the issuer or guarantor.

4060.3.5.2.3 Loans Secured by First Liens on One- to Four-Family Residential Properties or Multifamily Residential Properties

Qualifying one- to four-family residential properties, either owner-occupied or rented, or multifamily residential properties (as listed in the instructions to the bank holding company FR Y-9C Report), are accorded preferential risk-weighting treatment under the guidelines. These loans include loans to builders with substantial project equity for the construction of one- to four-family residential properties that have been presold under firm contracts to purchasers who have obtained firm commitments for permanent qualifying mortgage loans and have made substantial earnest-money deposits.[10] Effective with an April 1, 1999, amendment, such loans to builders will be considered prudently underwritten only if the bank holding company has obtained sufficient documentation that the buyer of the home intends to purchase the home (that is, has a legally binding written sales contract). The buyer must have the ability to obtain a mortgage sufficient to purchase the home (that is, has a firm written commitment for permanent financing of the home upon completion).

To ensure that only qualifying residential mortgage loans are assigned to the 50 percent risk-weight category, examiners are to review the real estate loans that are included in that category. Such loans are not eligible for preferential treatment unless the loans are made subject to prudent credit underwriting standards; the loan-to-value ratios are conservative;[11] the loan-to-value ratios[12] are based on the most current appraisal or evaluation[13] of the properties, with such appraisal or evaluation conforming to both the Board's real estate appraisal regulations and guidelines and the banking organization's internal appraisal guidelines; and the

10. An amendment, effective December 29, 1992, lowered from 100 to 50 percent the risk weight on loans to finance the construction of one- to four-family residences that have been presold.

11. Prudent underwriting standards dictate that a loan-to-value ratio used in the case of originating a loan to acquire a property would not be deemed conservative unless the value is based on the lower of the acquisition cost of the property or the appraised (or, if appropriate, evaluated) value. Otherwise, the loan-to-value ratio generally would be based on the value of the property as determined by the most current appraisal or, if appropriate, the most current evaluation. All appraisals and evaluations must be made in a manner consistent with the federal banking agencies' real estate appraisal regulations and guidelines and with the banking organization's own appraisal guidelines.

12. If a banking organization holds the first and junior lien(s) on a residential property and no other party holds an intervening lien, the transaction is treated as a single loan secured by a first lien for the purposes of determining the loan-to-value ratio and assigning a risk weight.

13. Appraisals made at the inception of one- to four-family residential property loans are to be used in calculating loan-to-value ratios. Subsequent appraisals showing increased property values may be used to support higher loan-to-value ratios. However, to avoid penalizing banking organizations doing business in markets with declining real estate values, appraisals of residential properties as conducted at inception are to be used in calculating loan-to-value ratios, even though more current appraisals showing decreases in values are available.

loans are performing in accordance with their original terms and are not 90 days or more past due or carried in nonaccrual status.

Where examiners find that some residential mortgage loans do not meet all the specified criteria or are made for the purpose of speculative real estate development, such loans should be assigned to the 100 percent risk-weight category in accordance with the guidelines.

Examiners should keep in mind that loans secured by multifamily residential property must meet additional criteria to be included in the 50 percent risk-weight category. These include the requirement that all principal and interest payments on the loan must have been made on time for at least the year preceding the placement of the loan in this risk-weight category. If the existing property owner is refinancing a loan on that property, all principal and interest payments on the loan being refinanced must have been made on time for at least the year preceding placement in this risk-weight category. In addition, amortization of the principal and interest must occur over a period of not more than 30 years and the minimum original maturity for repayment of principal must not be less than seven years. Also, the annual net operating income (before debt service) generated by the property during its most recent fiscal year must not be less than 120 percent of the loan's current annual debt service (115 percent if the loan is based on a floating interest rate) or, in the case of a cooperative or other not-for-profit housing project, the property must generate sufficient cash flow to provide comparable protection to the institution.

If examiners find material evidence of residential mortgage loans having questionable eligibility for preferential risk-weighting, but cannot readily identify the amounts that were inappropriately weighted, the overall evaluation of the banking organization's capital adequacy should reflect a higher capital requirement than otherwise would be the case.

4060.3.5.2.4 Small-Business Loans and Leases on Personal Property Transferred with Recourse

A qualifying banking organization (that is, a bank holding company) that has transferred small-business loans and leases on personal property (small-business obligations) with recourse can include in weighted-risk assets only the amount of retained recourse, provided two conditions are met. First, the transaction must be treated as a sale under GAAP and, second, the banking organization must establish pursuant to GAAP a noncapital reserve sufficient to meet the organization's reasonably estimated liability under the recourse arrangement. Only loans and leases to businesses that meet the criteria for a small-business concern established by the Small Business Administration under section 3(a) of the Small Business Act are eligible for this capital treatment.

A banking organization qualifies if it meets the criteria for well capitalized or, by order of the Board, adequately capitalized, as those criteria are set forth in the Board's prompt-corrective-action regulation for state member banks (12 C.F.R. 208.40). For purposes of determining whether an organization meets these criteria, its capital ratios must be calculated without regard to the capital treatment for transfers of small-business obligations with recourse. The total outstanding amount of recourse retained by a qualifying banking organization on transfers of small-business obligations receiving the preferential capital treatment cannot exceed 15 percent of the organization's total risk-based capital. By order, the Board may approve a higher limit.

If a bank holding company ceases to be qualifying or exceeds the 15 percent capital limitation, the preferential capital treatment will continue to apply to any transfers of small-business obligations with recourse that were consummated during the time that the organization was qualifying and did not exceed the capital limit.

4060.3.5.3 Certain Off-Balance-Sheet Activity Considerations

4060.3.5.3.1 Securities Lent

Examiners are to review securities-lent transactions of banking organizations and verify that, when banking organizations have risk of loss as either principal or agent, the transaction is converted at 100 percent and assigned to the appropriate risk-weight category. The guidelines treat securities lent in two ways, depending on the nature of the transactions and the risk of loss. If banking organizations are acting as their customers' agent and do not indemnify their customers against loss, the amount of securities lent is excluded from risk-based capital calculations. If banking organizations lend their own securities or, acting as an agent for a customer,

lend the customers' securities and indemnify their customers against loss, the amount of securities lent is converted at 100 percent and assigned the risk weight appropriate to the obligor, or to any collateral delivered to the lending banking organizations or the independent custodians acting on the lenders' behalf.

If securities lent are secured by cash on deposit in subsidiary lending institutions, the appropriate risk weight is either zero or 20 percent,

depending on qualification criteria. Claims collateralized by cash on deposit in subsidiary lending institutions for which a margin of collateral is maintained on a daily basis—fully taking into account any change in the bank's exposure to the obligor or counterparty under a claim in relation to the market value of the collateral held in support of that claim—are assigned the zero risk weight. When securities lent are collateralized by cash on deposit in subsidiary lending institutions for which a daily margin is not maintained, the cash collateral is assigned a 20 percent risk weight.

When a banking organization is acting as agent for a customer in a transaction involving the lending or sale of securities that is collateralized by cash delivered to the banking organization, the transaction is deemed to be collateralized by cash on deposit in a subsidiary lending institution for purposes of determining the appropriate risk-weight category, provided that any indemnification is limited to no more than the difference between the market value of the securities and the cash collateral received and any reinvestment risk associated with that cash collateral is borne by the customer.

4060.3.5.3.2 Commitments to Make Off-Balance-Sheet Transactions

A commitment to make a standby letter of credit is considered to be a standby letter of credit. Accordingly, such a commitment should be converted to an on-balance-sheet credit-equivalent amount at 100 percent if it is a commitment to make a financial standby letter of credit or at 50 percent if it is a commitment to make a performance standby letter of credit.

A commitment to make a commitment is treated as a single commitment whose maturity is the combined maturity of the two commitments. For example, a six-month commitment to make a one-year commitment is considered to be a single eighteen-month commitment. Because the maturity is over one year, such a commitment would be accorded the 50 percent conversion factor appropriate to long-term commitments, rather than the zero percent conversion factor that would be accorded to separate unrelated short-term commitments of six months and one year.

A commitment to make a commercial letter of credit may be treated as either a commitment or a commercial letter of credit, whichever results in the lower conversion factor. Normally, this would mean that a commitment under one year to make a commercial letter of credit would be treated as a commitment and converted at zero percent, while a similar commitment of over one year would be treated as a commercial letter of credit and converted at 20 percent.

If a commitment facility is structured so that it can be drawn down in several forms, such as a standby letter of credit, a loan, or a commercial letter of credit, the entire facility should be treated as a commitment to extend credit in the form that incurs the highest capital charge. Thus, if a facility could be drawn down in any of the three forms just cited, the entire facility would be treated as a commitment to issue a standby letter of credit and would be converted at 100 percent rather than being treated as a commitment to make a loan or commercial letter of credit, which would have a lower conversion factor.

4060.3.5.3.3 Unused Commitments

Unused commitments (including underwriting commitments and commercial and consumer credit commitments) that have an original maturity of one year or less are converted at zero percent, as are commitments that are unconditionally cancelable at any time at the option of the banking organization, provided that a separate credit decision is made before each drawing under the facility. Unused commitments with an original maturity of over one year are converted at 50 percent.

''Original maturity'' is defined as the length of time between the date the commitment is issued and the earliest date on which (1) the banking organization can, at its option, unconditionally cancel[14] the commitment *and* (2) the banking organization is scheduled to (and as a normal practice actually does) review the facility to determine whether or not the unused commitment should be extended. See SR-90-23 regarding loan commitments and put options.

Banking organizations must continue to review unused commitments at least annually to determine that they qualify for short-term commitment treatment. Examiners are to review unused commitments to determine that they meet the conditions for being treated as short-term or long-term and are appropriately weighted for risk-based capital calculations.

14. Does not refer to material-adverse-change clauses.

A commitment may be issued that expires within one year with the understanding that the commitment will be renewed upon expiration subject to a thorough credit review of the obligor. Such a commitment may be converted at zero percent only if (1) the renegotiation process is carried out in good faith, involves a full credit assessment of the obligor, and allows the bank holding company flexibility to alter the terms and conditions of the new commitment; (2) it has absolute discretion to decline renewal or extension of the commitment; and (3) the renegotiated commitment expires within 12 months from the time it is made. Some commitments contain unusual renegotiation arrangements that would give the borrower a considerable amount of advance notice that a commitment would not be renewed. Provisions of this kind can have the effect of creating a rolling-commitment arrangement that should be treated for risk-based capital purposes as a long-term commitment and, thus, be converted to a credit-equivalent amount at 50 percent. Normally, the renegotiation process should take no more than six to eight weeks, and in many cases it should take less time. The renegotiation period should immediately precede the expiration date of the commitment. The reasons for provisions in a commitment arrangement that would appear to provide for a protracted renegotiation period should be thoroughly documented by the bank holding company and reviewed by the examiner.

A commitment may be structured to be drawn down in a number of tranches, some exercisable in one year or less and others exercisable in over one year. The full amount of such a commitment is deemed to be over one year and converted at 50 percent. Some long-term commitments may permit the customer to draw down varying amounts at different times to accommodate, for example, seasonal borrowing needs. The 50 percent conversion factor should be applied to the maximum amount that could be drawn down under such commitments.

4060.3.5.3.4 Derivative Contracts (Interest-Rate, Exchange-Rate, and Commodity- (Including Precious Metals) and Equity-Linked Contracts)

Credit-equivalent amounts are computed for each of the following off-balance-sheet contracts:

1. interest-rate contracts
   a. single-currency interest-rate swaps
   b. basis swaps
   c. forward-rate agreements
   d. interest-rate options purchased (including caps, collars, and floors purchased)
   e. any other instrument linked to interest rates that gives rise to similar credit risks (including when-issued securities and forward forward deposits accepted)
2. exchange-rate contracts
   a. cross-currency interest-rate swaps
   b. forward foreign-exchange-rate contracts
   c. currency options purchased
   d. any other instrument linked to exchange rates that gives rise to similar credit risks
3. equity derivative contracts
   a. equity-linked swaps
   b. equity-linked options purchased
   c. forward equity-linked contracts
   d. any other instrument linked to equities that gives rise to similar credit risks
4. commodity (including precious metal) derivative contracts
   a. commodity-linked swaps
   b. commodity-linked options purchased
   c. forward commodity-linked contracts
   d. any other instrument linked to commodities that gives rise to similar credit risks

Derivative Contract Exceptions. Exchange-rate contracts with an original maturity of 14 or fewer calendar days and derivative contracts traded on exchanges that require daily receipt and payment of cash variation margin may be excluded from the risk-based ratio calculation. Gold contracts are accorded the same treatment as exchange-rate contracts except that gold contracts with an original maturity of 14 or fewer calendar days are included in the risk-based ratio calculation. Over-the-counter options purchased are included and treated in the same way as other derivative contracts.

4060.3.5.3.4.1 Calculation of Credit-Equivalent Amounts and the Application of Risk Weights

The credit-equivalent amount of a derivative contract that is not subject to a qualifying bilateral netting contract in accordance with subsection 4060.3.5.3.4 above is equal to the sum of—

1. the current exposure (sometimes referred to as the replacement cost) of the contract and
2. an estimate of the potential future credit exposure of the contract.

The current exposure is determined by the mark-to-market value of the contract. If the

mark-to-market value is positive, then the current exposure is equal to that mark-to-market value. If the mark-to-market value is zero or negative, then the current exposure is zero. Mark-to-market values are measured in dollars, regardless of the currency or currencies specified in the contract, and should reflect changes in the relevant rates, as well as in counterparty credit quality.

The potential future credit exposure of a contract, including a contract with a negative mark-to-market value, is estimated by multiplying the notional principal amount of the contract by a credit-conversion factor. Banking organizations should use, subject to examiner review, the effective rather than the apparent or stated notional amount in this calculation. The conversion factors (in percent) are listed below.

For a contract that is structured such that on specified dates any outstanding exposure is settled and the terms are reset so that the market value of the contract is zero, the remaining maturity is equal to the time until the next reset date. For an interest-rate contract with a remaining maturity of more than one year that meets these criteria, the minimum conversion factor is 0.5 percent.

For a contract with multiple exchanges of principal, the conversion factor is multiplied by the number of remaining payments in the contract. A derivative contract not included in the definitions of interest-rate, exchange-rate, equity, or commodity contracts as set forth in subsection 4060.3.5.3.4 is subject to the same conversion factors as a commodity, excluding precious metals.

No potential future credit exposure is calculated for a single-currency interest-rate swap in which payments are made based on two floating-rate indices, so-called floating/floating or basis swaps; the credit exposure on these contracts is evaluated solely on the basis of their mark-to-market values.

The Board has noted that these conversion factors, which are based on observed volatilities of the particular types of instruments, are subject to review and modification in light of changing volatilities or market conditions.

100 Percent Credit-Conversion Factor for Off-Balance-Sheet Items for BHCs

1. Direct credit substitutes (These include general guarantees of indebtedness and all guarantee-type instruments, including standby letters of credit backing the financial obligations of other parties.)

2. Risk participations in banker's acceptances and direct credit substitutes, such as standby letters of credit

3. Sale and repurchase agreements and assets sold with recourse that are not included on the balance sheet

4. Forward agreements to purchase assets, including financing facilities, on which drawdown is certain

5. Securities lent for which the banking organization is at risk

50 Percent Conversion Factor

1. Transaction-related contingencies (These include bid-bonds, performance bonds, warranties, and standby letters of credit backing the nonfinancial performance of other parties.)

CONVERSION FACTORS

[in percent]

Remaining maturity	*Interest-rate*	*Exchange-rate and gold*	*Equity*	*Commodity, excluding precious metals*	*Precious metals, except gold*
One year or less	0.0	1.0	6.0	10.0	7.0
Over one to five years	0.5	5.0	8.0	12.0	7.0
Over five years	1.5	7.5	10.0	15.0	8.0

2. Unused portions of commitments with an original maturity exceeding one year, including underwriting commitments and commercial credit lines

3. Revolving underwriting facilities (RUFs), note issuance facilities (NIFs), and similar arrangements

20 Percent Conversion Factor

Short-term, self-liquidating, trade-related contingencies, including commercial letters of credit

Zero Percent Conversion Factor

Unused portions of commitments with an original maturity of one year or less, or which are unconditionally cancelable at any time, provided a separate credit decision is made before each drawing

Examples of the calculation of credit-equivalent amounts for these instruments are shown on the following page.

CALCULATI NG CREDIT-EQUIVALENT AMOUNTS FOR DERIVATIVE CONTRACTS

Type of contract	*Notional principal amount*	*Conversion factor*	*Potential exposure (dollars)*	*Mark-to-market*	*Current exposure (dollars)*	*Credit-equivalent amount*
(1) 120-day forward foreign exchange	5,000,000	.01	50,000	100,000	100,000	150,000
(2) 4-year forward foreign exchange	6,000,000	.05	300,000	–120,000	0	300,000
(3) 3-year single-currency fixed and floating interest-rate swap	10,000,000	.005	50,000	200,000	200,000	250,000
(4) 6-month oil swap	10,000,000	.10	1,000,000	–250,000	0	1,000,000
(5) 7-year cross-currency floating and floating interest-rate swap	20,000,000	.075	1,500,000	–1,500,000	0	1,500,000
TOTAL			2,900,000	+	300,000 =	3,200,000

If contracts (1) through (5) above are subject to a qualifying bilateral netting contract, then the following applies:

Contract	*Potential future exposure*	*Net current exposure*	*Credit-equivalent amount*
(1)	50,000		
(2)	300,000		
(3)	50,000		
(4)	1,000,000		
(5)	1,500,000		
TOTAL	2,900,000	+ 0 =	2,900,000

Note: The total of the mark-to-market values from the first table is –$1,570,000. Since this is a negative amount, the net current exposure is zero.

To recognize the effects of bilateral netting on potential future exposure the following formula applies:

$$A_{net} = (0.4 \times A_{gross}) + 0.6(NGR \times A_{gross})$$

In the above example, where the net current exposure is zero, the credit-equivalent amount would be calculated as follows:

$$NGR = 0 = (0/300,000)$$

$$A_{net} = (0.4 \times \$2,900,000) + .6(0 \times \$2,900,000)$$

$$A_{net} = \$1,160,000$$

The credit-equivalent amount is

$$\$1,160,000 + 0 = \$1,160,000.$$

If the net current exposure was a positive number, for example $200,000, the credit equivalent would be calculated as follows:

$$NGR = .67 = (\$200,000/\$300,000)$$

$$A_{net} = (0.4 \times \$2,900,000) + 0.6(.67 \times \$2,900,000)$$

$$A_{net} = \$2,325,800$$

The credit-equivalent amount would be $2,325,800 + $200,000 = $2,525,800.

Applying Risk Weights. Once the credit-equivalent amount for a derivative contract, or a group of derivative contracts subject to a qualifying bilateral netting contract, has been determined, that amount is assigned to the risk-weight category appropriate to the counterparty, or, if relevant, the guarantor or the nature of any collateral.[15] However, the maximum weight that will be applied to the credit-equivalent amount of such contracts is 50 percent.

4060.3.5.3.4.2 Avoidance of Double Counting of Derivative Contracts

In certain cases, credit exposures arising from derivative contracts may be reflected, in part, on the balance sheet. To avoid double counting such exposures in the assessment of capital adequacy and, perhaps, assigning inappropriate risk weights, counterparty credit exposures arising from the derivative instruments covered by the guidelines may need to be excluded by examiners from balance-sheet assets in calculating a banking organization's risk-based capital ratios. This exclusion will eliminate the possibility that an organization could be required to hold capital against both an off-balance-sheet and on-balance-sheet amount for the same item. This treatment is not accorded to margin accounts and accrued receivables related to interest-rate and exchange-rate contracts.

The aggregate on-balance-sheet amount excluded from the risk-based capital calculation is equal to the lower of—

1. each contract's positive on-balance-sheet amount or
2. its positive market value included in the off-balance-sheet risk-based capital calculation.

For example, a forward contract that is marked to market will have the same market value on the balance sheet as is used in calculating the credit-equivalent amount for off-balance-sheet exposures under the guidelines. Therefore, the on-balance-sheet amount is not included in the risk-based capital calculation. Where either the contract's on-balance-sheet amount or its market value is negative or zero, no deduction from on-balance-sheet items is necessary for that contract.

If the positive on-balance-sheet asset amount exceeds the contract's market value, the excess (up to the amount of the on-balance-sheet asset) should be included in the appropriate risk-weight category. For example, a purchased option will often have an on-balance-sheet amount equal to the fee paid until the option expires. If that amount exceeds market value, the excess of carrying value over market value would be included in the appropriate risk-weight category for purposes of the on-balance-sheet portion of the calculation.

4060.3.5.3.5 Treatment of Commodity and Equity Contracts

Credit-equivalent amounts of swap agreements and futures, forwards, and option contracts on commodities, equities, and equity indexes are calculated in the same way as credit-equivalent amounts of foreign-exchange-rate contracts. Contracts on commodities, equities, and equity

15. For derivative contracts, sufficiency of collateral or guarantees is determined by the market value of the collateral or the amount of the guarantee in relation to the credit-equivalent amount. Collateral and guarantees are subject to the same provisions noted under section III.B. of appendix A of Regulation Y.

indexes traded on exchanges that require daily payment of variation margin are excluded from the risk-based capital calculation. Such a margining arrangement requires the marking to market of contracts and the settling of the resulting gains and losses in cash on a daily basis.

4060.3.5.3.6 Netting of Swaps and Similar Contracts

Netting refers to the offsetting of positive and negative mark-to-market values in the determination of a current exposure to be used in the calculation of a credit-equivalent amount. Any legally enforceable form of bilateral netting (that is, netting with a single counterparty) of derivative contracts is recognized for purposes of calculating the credit-equivalent amount provided that—

1. the netting is accomplished under a written netting contract that creates a single legal obligation, covering all included individual contracts, with the effect that the organization would have a claim to receive, or an obligation to receive or pay, only the net amount of the sum of the positive and negative mark-to-market values on included individual contracts in the event that a counterparty, or a counterparty to whom the contract has been validly assigned, fails to perform due to default, insolvency, liquidation, or similar circumstances;

2. the banking organization obtains written and reasoned legal opinions that in the event of a legal challenge—including one resulting from default, insolvency, liquidation, or similar circumstances—the relevant court and administrative authorities would find the banking organization's exposure to be such a net amount under—

a. the law of the jurisdiction in which the counterparty is chartered or the equivalent location in the case of noncorporate entities, and if a branch of the counterparty is involved, then also under the law of the jurisdiction in which the branch is located;

b. the law that governs the individual contracts covered by the netting contract; and

c. the law that governs the netting contract;

3. the banking organization establishes and maintains procedures to ensure that the legal characteristics of netting contracts are kept under review in light of possible changes in relevant law; and

4. the banking organization maintains in its files documentation adequate to support the netting of rate contracts, including a copy of the bilateral netting contract and necessary legal opinions.

A contract containing a walkaway clause is not eligible for netting for purposes of calculating the credit-equivalent amount.[16]

By netting individual contracts for the purpose of calculating credit-equivalent amounts of derivative contracts, a banking organization represents that it has met the requirements of the risk-based measure of the capital adequacy guidelines for BHCs and that all the appropriate documents are in the organization's files and available for inspection by the Federal Reserve. The Federal Reserve may determine that a banking organization's files are inadequate or that a netting contract, or any of its underlying individual contracts, may not be legally enforceable. If such a determination is made, the netting contract may be disqualified from recognition for risk-based capital purposes or underlying individual contracts may be treated as though they are not subject to the netting contract.

The credit-equivalent amount of contracts that are subject to a qualifying bilateral netting contract is calculated by adding—

1. the current exposure of the netting contract (net current exposure) and

2. the sum of the estimates of the potential future credit exposures on all individual contracts subject to the netting contract (gross potential future exposure) adjusted to reflect the effects of the netting contract.[17]

The net current exposure of the netting contract is determined by summing all positive and negative mark-to-market values of the individual contracts included in the netting contract. If the net sum of the mark-to-market values is positive, then the current exposure of the netting contract is equal to that sum. If the net sum of the mark-to-market values is zero or negative, then the current exposure of the netting contract is zero. The Federal Reserve may determine that a netting contract qualifies for risk-based capital netting treatment even though certain individual

16. A walkaway clause is a provision in a netting contract that permits a nondefaulting counterparty to make lower payments than it would make otherwise under the contract, or no payment at all, to a defaulter or to the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the contract.

17. For purposes of calculating potential future credit exposure to a netting counterparty for foreign-exchange contracts and other similar contracts in which notional principal is equivalent to cash flows, total notional principal is defined as the net receipts falling due on each value date in each currency.

contracts may not qualify. In such instances, the nonqualifying contracts should be treated as individual contracts that are not subject to the netting contract.

Gross potential future exposure or A_{gross} is calculated by summing the estimates of potential future exposure (determined in accordance with subsection 4060.3.5.3.4.1) for each individual contract subject to the qualifying bilateral netting contract.

The effects of the bilateral netting contract on the gross potential future exposure are recognized through the application of a formula that results in an adjusted add-on amount (A_{net}). The formula, which employs the ratio of net current exposure to gross current exposure (NGR), is expressed as:

$$A_{net} = (0.4 \times A_{gross}) + 0.6(NGR \times A_{gross})$$

The NGR may be calculated in accordance with either the counterparty-by-counterparty approach or the aggregate approach.

Under the counterparty-by-counterparty approach, the NGR is the ratio of the net current exposure for a netting contract to the gross current exposure of the netting contract. The gross current exposure is the sum of the current exposures of all individual contracts subject to the netting contract calculated in accordance with subsection 4060.3.5.3.4.1. Net negative mark-to-market values for individual netting contracts with the same counterparty may not be used to offset net positive mark-to-market values for other netting contracts with the same counterparty.

Under the aggregate approach, the NGR is the ratio of the sum of all the net current exposures for qualifying bilateral netting contracts to the sum of all the gross current exposures for those netting contracts (each gross current exposure is calculated in the same manner as in subsection 4060.3.5.3.6 (counterparty-by-counterparty approach)). Net negative mark-to-market values for individual counterparties may not be used to offset net positive current exposures for other counterparties.

A banking organization must consistently use either the counterparty-by-counterparty approach or the aggregate approach to calculate the NGR. Regardless of the approach used, the NGR should be applied individually to each qualifying bilateral netting contract to determine the adjusted add-on for that netting contract.

In the event a netting contract covers contracts that are normally excluded from the risk-based ratio calculation—for example, exchange-rate contracts with an original maturity of 14 or fewer calendar days or instruments traded on exchanges that require daily payment of cash variation margin—an institution may elect to either include or exclude all mark-to-market values of such contracts when determining net current exposure, provided the method chosen is applied consistently.

Examiners are to review the netting of off-balance-sheet derivative contractual arrangements used by banking organizations when calculating or verifying risk-based capital ratios to ensure that the positions of such contracts are reported gross unless the net positions of those contracts reflect netting arrangements that comply with the netting requirements listed previously.

4060.3.5.3.7 Treatment of Assets Sold with Recourse

For capital adequacy purposes, a bank holding company must hold capital against assets sold with recourse if any risk of loss is retained, regardless of how the transaction is reported. As a general rule, bank holding companies report all assets sold with recourse in accordance with the Financial Accounting Standards Board (FASB) Statement No. 77, "Reporting of Transferors for Transfers of Receivables with Recourse." Therefore, many of the holding company's assets sold with recourse are treated as sales of the underlying assets and removed from the company's balance sheet. (In accordance with FASB Statement No. 77, the holding company must also book a liability reserve for the amount of the expected loss.)

The outstanding amount of the assets sold with recourse that are removed from the holding company's balance sheet must be reported, for purposes of regulatory financial statement reporting, as an off-balance-sheet transaction. For risk-based capital purposes, bank holding companies must hold capital against the entire amount of those assets reported as off-balance-sheet transactions and convert them to a credit-equivalent amount at 100 percent. Such assets must then be assigned to the risk category appropriate to the obligor or, if relevant, the guarantor or nature of the collateral, provided that the transactions meet the definition of assets sold with recourse, including assets sold subject to *pro rata* and other loss-sharing arrange-

ments.[18] This treatment applies to the sale, with recourse, of any assets, including the sale of one- to four-family and multifamily residential mortgages, with one limited exception.

The limited exception applies to transfers of pools of residential mortgages that have been made with insignificant recourse for which a liability or specific noncapital reserve has been established and is maintained for the maximum amount of possible loss under the recourse provision. No capital charge is assessed on transfers of pools of residential mortgages, either under government-related programs or to private obligors, if the maximum possible recourse obligation at the time of the transfer is less than the expected loss on the transferred assets and if a liability or a specifically identified noncapital reserve is established and maintained in an amount equal to the maximum loss possible under the recourse provision. Under this arrangement, at the time of sale, the transferring banking organization effectively reduces current earnings and, thus, capital (through the retained earnings account) by the amount of the maximum possible loss, and is not subject to further loss.

4060.3.5.3.8 Financial Standby Letters of Credit and Performance Standby Letters of Credit

The determining characteristic of whether a standby letter of credit is financial or performance is the contractual obligation that triggers payment. If the event that triggers payment is financial, such as a failure to pay money, the standby letter of credit should be classified as financial. If the event that triggers payment is performance-related, such as a failure to ship a product or provide a service, the standby letter of credit should be classified as performance. The vast majority of standby letters of credit a bank issues are considered, for risk-based capital purposes, to be financial standby letters of credit. (See SR-95-20 (SUP).)

4060.3.5.3.8.1 Financial Standby Letters of Credit

The risk-based capital guidelines describe a financial standby letter of credit as an irrevocable undertaking by a banking organization to guarantee repayment of a financial obligation. Such a guarantee is considered a direct credit substitute and is converted to an on-balance-sheet credit-equivalent amount at 100 percent. The resulting credit-equivalent amount is then risk-weighted according to the type of counterparty or, if relevant, to any guarantee or collateral.

Financial standby letters of credit have a higher conversion factor than performance standby letters of credit. This is primarily because, unlike performance standby letters of credit, financial standby letters of credit tend to be drawn down only when the account party's financial condition has deteriorated.

A standby letter of credit guaranteeing the performance of a contractual obligation to pay money is viewed as a financial letter of credit. For example, a standby letter of credit backing a purchaser's contractual obligation to pay for delivered goods is a financial guarantee backing the purchaser's credit standing for the sale. It would not be viewed as a performance letter of credit guaranteeing the purchaser's performance to make payment under the contract.

A failure to perform a contractual obligation involving the payment of money can arise in a variety of situations, for example, failure to pay insurance premiums or deductibles, failure to pay insurance claims, failure to pay worker's compensation obligations, or failure to pay for (or arrange) cleanup in the event the account party's operations cause environmental damage. In each instance, the triggering event is the failure to pay money under a contractual obligation. A standby letter of credit guaranteeing payment in the event the account party fails to perform any of these contractual financial obligations or other circumstances should be treated as a financial standby letter of credit and converted to an on-balance-sheet credit-equivalent amount at 100 percent.

4060.3.5.3.8.2 Performance Standby Letters of Credit

A performance standby letter of credit is an irrevocable undertaking by the organization to

18. The terms of a transfer of assets with recourse may contractually limit the amount of the institution's liability to an amount less than the effective risk-based capital requirement for the assets being transferred with recourse. If such a transaction is recognized as a sale under GAAP, the amount of total capital required is equal to the maximum amount of loss possible under the recourse provision less any amount held in an associated noncapital liability account established pursuant to GAAP to cover estimated probable losses under the recourse provision.

make payment in the event the customer fails to perform a nonfinancial contractual obligation. This type of letter of credit is considered a transaction-related contingency and is converted to an on-balance-sheet credit-equivalent amount at 50 percent. The resulting credit-equivalent amount is then risk-weighted according to the type of counterparty or, if relevant, to any guarantee or collateral.

4060.3.5.3.9 Credit Derivatives

For purposes of risk-based capital, credit derivatives generally are to be treated as off-balance-sheet direct credit substitutes. They are arrangements that allow one party (the beneficiary) to transfer the credit risk of a "reference asset," which it often actually owns, to another party (the guarantor).[19] The notional amount of the contract should be converted at 100 percent to determine the credit-equivalent amount to be included in risk-weighted assets of the guarantor.[20] A banking organization providing a guarantee through a credit-derivative transaction should assign its credit exposure to the risk category appropriate to the obligor of the reference asset or any collateral. On the other hand, a banking organization that owns the underlying asset upon which effective credit protection has been acquired through a credit derivative may under certain circumstances assign the unamortized portion of the underlying asset to the risk category appropriate to the guarantor (for example, to the 20 percent risk category if the guarantor is a bank or, if a bank holding company, to the 100 percent risk-weight category).

Whether the credit derivative is considered an eligible guarantee for purposes of risk-based capital depends on the *degree of credit protection* actually provided, which may be limited depending on the terms of the arrangement. For example, a relatively restrictive definition of a default event or a materiality threshold that requires a comparably high percentage of loss to occur before the guarantor is obliged to pay could effectively limit the amount of credit risk actually transferred in the transaction. If the terms of the credit-derivative arrangement significantly limit the degree of risk transference, then the beneficiary bank cannot reduce the risk weight of the "protected" asset to that of the guarantor. On the other hand, even if the transfer of credit risk is limited, a banking organization providing limited credit protection through a credit derivative should hold appropriate capital against the underlying exposure while the organization is exposed to the credit risk of the reference asset.

Banking organizations providing a guarantee through a credit derivative may mitigate the credit risk associated with the transaction by entering into an offsetting credit derivative with another counterparty, a so-called "back-to-back" position. Organizations that have entered into such a position may treat the first credit derivative as guaranteed by the offsetting transaction for risk-based capital purposes. Accordingly, the notional amount of the first credit derivative may be assigned to the risk category appropriate to the counterparty providing credit protection through the offsetting credit-derivative arrangement (for example, to the 20 percent risk category if the counterparty is an OECD bank).

In some instances, the reference asset in the credit-derivative transaction may not be identical to the underlying asset for which the beneficiary has acquired credit protection. For example, a credit derivative used to offset the credit exposure of a loan to a corporate customer may use a publicly traded corporate bond of the customer as the reference asset, whose credit quality serves as a proxy for the on-balance-sheet loan. In such a case, the underlying asset will still generally be considered guaranteed for capital purposes as long as both the underlying asset and the reference asset are obligations of the same legal entity and have the same level of seniority in bankruptcy. In addition, banking organizations offsetting credit exposure in this manner would be obligated to demonstrate to examiners that there is a high degree of correlation between the two instruments; the reference instrument is a reasonable and sufficiently liquid proxy for the underlying asset so that the instruments can be reasonably expected to behave similarly in the event of default; and, at a minimum, the reference asset and underlying asset are subject to mutual cross-default provisions. A

19. Once the market-risk capital rules are used, after January 1, 1997, credit derivatives that are held in a banking organization's (a bank's or bank holding company's) trading account will be subject to those rules. The rules are required to be effective by January 1, 1998, but early application is permitted, subject to appropriate supervisory approval.

20. Guarantor banks or bank holding companies that have made cash payments representing depreciation on reference assets may deduct such payments from the notional amount when computing credit-equivalent amounts for capital purposes. For example, if a guarantor bank or bank holding company makes a depreciation payment of $10 on a $100 notional total-rate-of-return swap, the credit-equivalent amount would be $90.

banking organization that uses a credit derivative, which is based on a reference asset that differs from the protected underlying asset, must document the credit derivative being used to offset credit risk and must link it directly to the asset or assets whose credit risk the transaction is designed to offset. The documentation and the effectiveness of the credit-derivative transaction are subject to examiner review. Banking organizations providing credit protection through such arrangements must hold capital against the risk exposures that are assumed.

4060.3.5.3.10 Credit Derivatives Used to Synthetically Replicate Collateralized Loan Obligations

Credit derivatives can be used to synthetically replicate collateralized loan obligations (CLOs). Banking organizations (BOs) can use CLOs and their synthetic variants to manage their balance sheets and, in some instances, transfer credit risk to the capital markets. Such transactions allow economic capital to be more efficiently allocated, resulting in, among other things, improved shareholders' returns. Supervisors and examiners need to fully understand these complex structures, and identify the relative degree of transference and retention of the securitized portfolio's credit risk. They must also determine whether the BO's regulatory risk-based and leverage capital is adequate given the retained credit exposures.[21]

A CLO is an asset-backed security that is usually supported by a variety of assets, including whole commercial loans, revolving credit facilities, letters of credit, banker's acceptances, or other asset-backed securities. In a typical CLO transaction, the sponsoring banking organization (SBO) transfers the loans and other assets to a bankruptcy-remote special-purpose vehicle (SPV), which then issues asset-backed securities consisting of one or more classes of debt. This type of transaction represents a so-called ''cash-flow CLO'' that enables the SBO to reduce its leverage and risk-based capital requirements, improve its liquidity, and manage credit concentrations.

The first synthetic CLO (issued in 1997) used credit-linked notes (CLNs).[22] Rather than transferring assets to the SPV, the sponsoring bank issued CLNs to the SPV, individually referencing the payment obligation of a particular company or ''reference obligor.'' The notional amount of the CLNs issued equaled the dollar amount of the reference assets the sponsor was hedging on its balance sheet. Other structures have evolved that use credit-default swaps to transfer credit risk and create different levels of risk exposure, but that hedge only a portion of the notional amount of the overall reference portfolio.[23]

Traditional CLO structures usually transfer assets into the SPV. In synthetic securitizations, the underlying exposures that make up the reference portfolio remain in the BO's banking book.[24] The credit risk is transferred into the SPV through credit-default swaps or CLNs. The BO is thus able to maintain client confidentiality and avoid sensitive client-relationship issues that arise from loan-transfer-notification requirements, loan-assignment provisions, and loan-participation restrictions

Corporate credits are assigned to the 100 percent risk-weighted asset category for risk-based capital calculation purposes. In the case of high-quality, investment-grade corporate exposures, the associated 8 percent capital requirement may exceed the economic capital that the SBO sets aside to cover the credit risk of the transaction. Therefore, one of the apparent motivations behind CLOs and other securitizations is to more closely align the SBO's regulatory capital requirements with the economic capital required by the market.

Synthetic CLOs can raise questions about their capital treatment when calculating the risk-based and leverage capital ratios. Capital treatments for three synthetic transactions follow. They are discussed from the perspective of the investors and the SBOs.

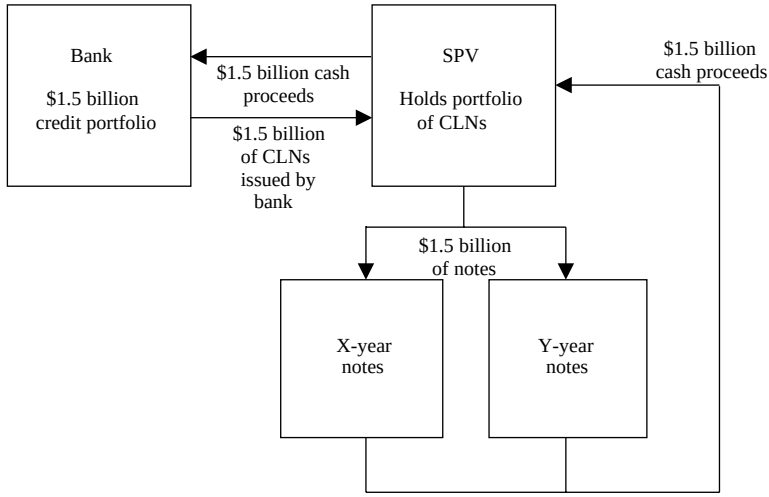
21. See SR-99-32 and its attached November 15, 1999, FRB-OCC capital interpretation on synthetic collateralized loan obligations.

22. CLNs are obligations whose principal repayment is conditioned upon the performance of a referenced asset or portfolio. The assets' performance may be based on a variety of measures, such as movements in price or credit spread, or the occurrence of default.

23. A credit-default swap is similar to a financial standby letter of credit in that the BO writing the swap provides, for a fee, credit protection against credit losses associated with a default on a specified reference asset or pool of assets.

24. ''Banking book'' refers to nontrading accounts. See the ''trading account'' definition in the Glossary for the instructions to the Consolidated Financial Statements for Bank Holding Companies, FR Y-9C.

Figure 1—Transaction 1



4060.3.5.3.10.1 Transaction 1—Entire Notional Amount of the Reference Portfolio Is Hedged

In the first type of synthetic securitization, the SBO, through a synthetic CLO, hedges the entire notional amount of a reference asset portfolio. An SPV acquires the credit risk on a reference portfolio by purchasing CLNs issued by the SBO. The SPV funds the purchase of the CLNs by issuing a series of notes in several tranches to third-party investors. The investor notes are in effect collateralized by the CLNs. Each CLN represents one obligor and the BO's credit-risk exposure to that obligor, which could take the form of bonds, commitments, loans, and counterparty exposures. Since the noteholders are exposed to the full amount of credit risk associated with the individual reference obligors, all of the credit risk of the reference portfolio is shifted from the SBO to the capital markets. The dollar amount of notes issued to investors equals the notional amount of the reference portfolio. In the example shown in figure 1, this amount is $1.5 billion.

If the obligor linked to a CLN in the SPV defaults, the SBO will call the individual CLN and redeem it based on the repayment terms specified in the note agreement. The term of each CLN is set so that the credit exposure (to which it is linked) matures before the maturity of the CLN, which ensures that the CLN will be in place for the full term of the exposure to which it is linked.

An investor in the notes issued by the SPV is exposed to the risk of default of the underlying reference assets, as well as to the risk that the SBO will not repay principal at the maturity of the notes. Because of the linkage between the credit quality of the SBO and the issued notes, a downgrade of the sponsor's credit rating most likely will result in the notes also being downgraded. Thus, a BO investing in this type of synthetic CLO should assign the notes to the higher of the risk categories appropriate to the underlying reference assets or the issuing entity.

For purposes of risk-based capital, the SBOs may treat the cash proceeds from the sale of CLNs that provide protection against underlying reference assets as cash collateralizing these assets.[25] This treatment would permit the reference assets, if carried on the SBO's books, to be assigned to the zero percent risk category to the extent that their notional amount is fully collateralized by cash. This treatment may be applied even if the cash collateral is transferred directly into the general operating funds of the BO and

25. The CLNs should not contain terms that would significantly limit the credit protection provided against the underlying reference assets, for example, a materiality threshold that requires a relatively high percentage of loss to occur before CLN payments are adversely affected, or a structuring of CLN post-default payments that does not adequately pass through credit-related losses on the reference assets to investors in the CLNs.

is not deposited in a segregated account. The synthetic CLO would not confer any benefits to the SBO for purposes of calculating its tier 1 leverage ratio, however, because the reference assets remain on the organization's balance sheet.

4060.3.5.3.10.2 Transaction 2—High-Quality, Senior Risk Position in the Reference Portfolio Is Retained

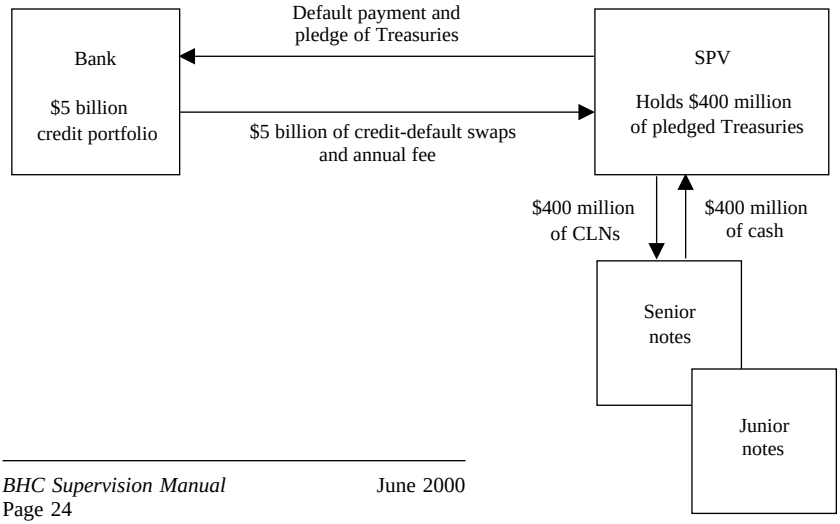
In the second type of synthetic CLO transaction, the SBO hedges a portion of the reference portfolio and retains a high-quality, senior risk position that absorbs only those credit losses in excess of the junior-loss positions. For some noted synthetic CLOs, the SBO used a combination of credit-default swaps and CLNs to transfer to the capital markets the credit risk of a designated portfolio of the organization's credit exposures. Such a transaction allows the SBO to allocate economic capital more efficiently and to significantly reduce its regulatory capital requirements.

In the structure illustrated in figure 2, the SBO purchases default protection from an SPV for a specifically identified portfolio of banking-book credit exposures, which may include letters of credit and loan commitments. The credit risk on the identified reference portfolio (which continues to remain in the sponsor's banking book) is transferred to the SPV through the use of credit-default swaps. In exchange for the credit protection, the SBO pays the SPV an annual fee. The default swaps on each of the obligors in the reference portfolio are structured to pay the average default losses on all senior unsecured obligations of defaulted borrowers. To support its guarantee, the SPV sells CLNs to investors and uses the cash proceeds to purchase U.S. government Treasury notes. The SPV then pledges the Treasuries to the SBO to cover any default losses.[26] The CLNs are often issued in multiple tranches of differing seniority and in an aggregate amount that is significantly less than the notional amount of the reference portfolio. The amount of notes issued typically is set at a level sufficient to cover some multiple of expected losses, but well below the notional amount of the reference portfolio being hedged.

There may be several levels of loss in this type of synthetic securitization. The first-loss position may consist of a small cash reserve, sufficient to cover expected losses. The cash reserve accumulates over a period of years and is funded from the excess of the SPV's income (that is, the yield on the Treasury securities plus the credit-default-swap fee) over the interest paid to investors on the notes. The investors in the SPV assume a second-loss position through their investment in the SPV's senior and junior notes, which tend to be rated AAA and BB,

26. The names of corporate obligors included in the reference portfolio may be disclosed to investors in the CLNs.

Figure 2—Transaction 2



respectively. Finally, the SBO retains a high-quality, senior risk position that would absorb any credit losses in the reference portfolio that exceed the first- and second-loss positions.

Typically, no default payments are made until the maturity of the overall transaction, regardless of when a reference obligor defaults. While operationally important to the SBO, this feature has the effect of ignoring the time value of money. Thus, the Federal Reserve expects that when the reference obligor defaults under the terms of the credit derivative and when the reference asset falls significantly in value, the SBO should, in accordance with generally accepted accounting principles, make appropriate adjustments in its regulatory reports to reflect the estimated loss that takes into account the time value of money.

For risk-based capital purposes, the BOs investing in the notes must assign them to the risk weight appropriate to the underlying reference assets.[27] The SBO must include in its risk-weighted assets its retained senior exposure in the reference portfolio, to the extent these underlying assets are held in its banking book. The portion of the reference portfolio that is collateralized by the pledged Treasury securities may be assigned a zero percent risk weight. Unless the SBO meets the stringent minimum conditions for transaction 2 outlined in the subsection ''Minimum Conditions,'' the remainder of the portfolio should be risk weighted according to the obligor of the exposures.

When the SBO has virtually eliminated its credit-risk exposure to the reference portfolio through the issuance of CLNs, and when the other minimum requirements are met, the SBO may assign the uncollateralized portion of its retained senior position in the reference portfolio to the 20 percent risk weight. However, to the extent that the reference portfolio includes loans and other on-balance-sheet assets, the SBO would not realize any benefits in the determination of its leverage ratio.

In addition to the three stringent minimum conditions, the Federal Reserve may impose other requirements, as it deems necessary to ensure that an SBO has virtually eliminated all of its credit exposure. Furthermore, the Federal Reserve retains the discretion to increase the risk-based capital requirement assessed against the retained senior exposure in these structures, if the underlying asset pool deteriorates significantly.

Federal Reserve staff will make a case-by-case determination, based on a qualitative review, as to whether the senior retained portion of an SBO's synthetic securitization qualifies for the 20 percent risk weight. The SBO must be able to demonstrate that virtually all the credit risk of the reference portfolio has been transferred from the banking book to the capital markets. As they do when BOs are engaging in more traditional securitization activities, examiners must carefully evaluate whether the SBO is fully capable of assessing the credit risk it retains in its banking book and whether it is adequately capitalized given its residual risk exposure. The Federal Reserve will require the SBO to maintain higher levels of capital if it is not deemed to be adequately capitalized given the retained residual risks. In addition, an SBO involved in synthetic securitizations must adequately disclose to the marketplace the effect of its transactions on its risk profile and capital adequacy.

The Federal Reserve may consider an SBO's failure to require the investors in the CLNs to absorb the credit losses that they contractually agreed to assume an unsafe and unsound banking practice. In addition, such a failure generally would constitute ''implicit recourse'' or support to the transaction, which result in the SBO's losing preferential capital treatment on its retained senior position.

If an SBO of a synthetic securitization does not meet the stringent minimum conditions, it may still reduce the risk-based capital requirement on the senior risk position retained in the banking book by transferring the remaining credit risk to a third-party OECD bank through the use of a credit derivative. Provided the credit derivative transaction qualifies as a guarantee under the risk-based capital guidelines, the risk weight on the senior position may be reduced from 100 percent to 20 percent. SBOs may not enter into nonsubstantive transactions that transfer banking-book items into the trading account to obtain lower regulatory capital requirements.[28]

27. Under this type of transaction, if a structure exposes investing BOs to the creditworthiness of a substantive issuer, for example, the SBO, then the investing BOs should assign the notes to the higher of the risk categories appropriate to the underlying reference assets or the SBO.

28. For instance, a lower risk weight would not be applied to a nonsubstantive transaction in which the SBO (1) enters into a credit derivative transaction to pass the credit risk of the senior retained portion held in its banking book to an OECD bank, and then (2) enters into a second credit derivative transaction with the same OECD bank, in which it reassumes into its trading account the credit risk initially transferred.

4060.3.5.3.10.3 Minimum Conditions

The following stringent minimum conditions are those that the SBOs must meet to use the synthetic securitization capital treatment for transaction 2. The Federal Reserve may impose additional requirements or conditions as deemed necessary to ascertain that an SBO has sufficiently isolated itself from the credit-risk exposure of the hedged reference portfolio.

Condition 1—Demonstration of transfer of virtually all the risk to third parties. Not all transactions structured as synthetic securitizations transfer the level of credit risk needed to receive the 20 percent risk weight on the retained senior position. To demonstrate that a transfer of virtually all of the risk has been achieved, SBOs must—

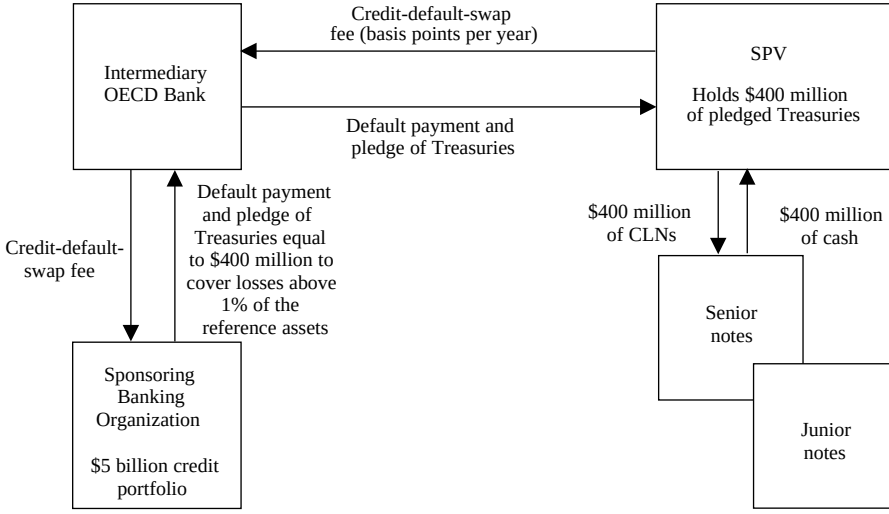
1. produce credible analyses indicating a transfer of virtually all the credit risk to substantive third parties;
2. ensure the absence of any early-amortization or other credit performance contingent clauses;[29]
3. subject the transaction to market discipline through the issuance of a substantive amount of notes or securities to the capital markets;
4. have notes or securities rated by a nationally recognized credit rating agency;
5. structure a senior class of notes that receives the highest possible investment grade rating, for example, AAA, from a nationally recognized credit rating agency;
6. ensure that any first-loss position retained by the SBO in the form of fees, reserves, or other credit enhancement—which effectively must be deducted from capital—is no greater than a reasonable estimate of expected losses on the reference portfolio; and
7. ensure that the SBO does not reassume any credit risk beyond the first-loss position through another credit derivative or any other means.

Condition 2—Demonstration of ability to evaluate remaining banking-book risk exposures and provide adequate capital support. To ensure that the SBO has adequate capital for the credit risk of its unhedged exposures, it is expected to have adequate systems that fully account for the effect of these transactions on its risk profiles and capital adequacy. In particular, the SBO's systems should be capable of fully differentiating the nature and quality of the risk exposures it transfers from the nature and quality of the risk exposures it retains. Specifically, to gain capital relief SBOs are expected to—

1. have a credible internal process for grading credit-risk exposures, including the following:
   a. adequate differentiation of risk among risk grades
   b. adequate controls to ensure the objectivity and consistency of the rating process
   c. analysis or evidence supporting the accuracy or appropriateness of the risk-grading system;
2. have a credible internal economic capital-assessment process that defines the SBO to be adequately capitalized at an appropriate insolvency probability and that readjusts, as necessary, its internal economic capital requirements to take into account the effect of the synthetic securitization transaction. In addition, the process should employ a sufficiently long time horizon to allow necessary adjustments in the event of significant losses. The results of an exercise demonstrating that the organization is adequately capitalized after the securitization transaction must be presented for examiner review;
3. evaluate the effect of the transaction on the nature and distribution of the nontransferred banking-book exposures. This analysis should include a comparison of the banking book's risk profile and economic capital requirements before and after the transaction, including the mix of exposures by risk grade and by business or economic sector. The analysis should also identify any concentrations of credit risk and maturity mismatches. Additionally, the SBO must adequately manage and control the forward credit exposure that arises from any maturity mismatch. The Federal Reserve retains the flexibility to require additional regulatory capital if the maturity mismatches are substantive enough to raise a supervisory concern. Moreover, as stated above, the SBO must demonstrate that it meets its internal economic capital requirement subsequent to the completion of the synthetic securitization;
4. perform rigorous and robust forward-looking stress testing on nontransferred exposures

29. Early-amortization clauses may generally be defined as features that are designed to force a wind-down of a securitization program and rapid repayment of principal to asset-backed securities investors if the credit quality of the underlying asset pool deteriorates significantly.

Figure 3—Transaction 3



(remaining banking-book loans and commitments), transferred exposures, and exposures retained to facilitate transfers (credit enhancements). The stress tests must demonstrate that the level of credit enhancement is sufficient to protect the SBO from losses under scenarios appropriate to the specific transaction.

Condition 3—Provide adequate public disclosures of synthetic CLO transactions regarding their risk profile and capital adequacy. In their 10-K and annual reports, SBOs must adequately disclose to the marketplace the accounting, economic, and regulatory consequences of synthetic CLO transactions. In particular, SBOs are expected to disclose—

1. the notional amount of loans and commitments involved in the transaction;
2. the amount of economic capital shed through the transaction;
3. the amount of reduction in risk-weighted assets and regulatory capital resulting from the transaction, both in dollar terms and in terms of the effect in basis points on the risk-based capital ratios; and
4. the effect of the transaction on the distribution and concentration of risk in the retained portfolio by risk grade and sector.

4060.3.5.3.10.4 Transaction 3—First-Loss Position Is Retained

In the third type of synthetic transaction, the SBO may retain a subordinated position that absorbs the credit risk associated with a first loss in a reference portfolio. Furthermore, through the use of credit-default swaps, the SBO may pass the second- and senior-loss positions to a third-party entity, most often an OECD bank. The third-party entity, acting as an intermediary, enters into offsetting credit-default swaps with an SPV, thus transferring its credit risk associated with the second-loss position to the SPV.[30] The SPV then issues CLNs to the capital markets for a portion of the reference portfolio and purchases Treasury collateral to cover some multiple of expected losses on the underlying exposures.

Two alternative approaches could be used to determine how the SBO should treat the overall transaction for risk-based capital purposes. The first approach employs an analogy to the low-

30. Because the credit risk of the senior position is not transferred to the capital markets but remains with the intermediary bank, the SBO should ensure that its counterparty is of high credit quality, for example, at least investment grade.

level capital rule for assets sold with recourse. Under this rule, a transfer of assets with recourse that contractually is limited to an amount less than the effective risk-based capital requirements for the transferred assets is assessed a total capital charge equal to the maximum amount of loss possible under the recourse obligation. If this rule applied to an SBO retaining a 1 percent first-loss position on a synthetically securitized portfolio that would otherwise be assessed 8 percent capital, the SBO would be required to hold dollar-for-dollar capital against the 1 percent first-loss risk position. The SBO would not be assessed a capital charge against the second- and senior-risk positions.[31]

The second approach employs a literal reading of the capital guidelines to determine the SBO's risk-based capital charge. In this instance, the 1 percent first-loss position retained by the SBO would be treated as a guarantee, that is, a direct credit substitute, which would be assessed an 8 percent capital charge against its face value of 1 percent. The second-loss position, which is collateralized by Treasury securities, would be viewed as fully collateralized and subject to a zero percent capital charge. The senior-loss position guaranteed by the intermediary bank would be assigned to the 20 percent risk category appropriate to claims guaranteed by OECD banks.[32]

The second approach may result in a higher risk-based capital requirement than the dollar-for-dollar capital charge imposed by the first approach, depending on whether the reference portfolio consists primarily of loans to private obligors or undrawn long-term commitments. The latter generally have an effective risk-based capital requirement one-half of the requirement for loans because these commitments are converted to an on-balance-sheet credit-equivalent amount using the 50 percent conversion factor. If the reference pool consists primarily of drawn loans to private obligors, then the capital requirement on the senior-loss position would be significantly higher than if the reference portfolio contained only undrawn long-term commitments. As a result, the capital charge for the overall transaction could be greater than the dollar-for-dollar capital requirement set forth in the first approach.

SBOs will be required to hold capital against a retained first-loss position in a synthetic securitization equal to the higher of the two capital charges resulting from application of the first and second approaches, as discussed above. Further, although the SBO retains only the credit risk associated with the first-loss position, it still should continue to monitor all the underlying credit exposures of the reference portfolio to detect any changes in the credit-risk profile of the counterparties. This is important to ensure that the SBO has adequate capital to protect against unexpected losses. Examiners should determine whether the SBO has the capability to assess and manage the retained risk in its credit portfolio after the synthetic securitization is completed. For risk-based capital purposes, BOs investing in the notes must assign them to the risk weight appropriate to the underlying reference assets.[33]

4060.3.5.4 Considerations in the Overall Assessment of Capital Adequacy

Examiners are to take into account the following factors when assessing the overall capital adequacy of banking organizations.

4060.3.5.4.1 Unrealized Asset Values

Banking organizations often have assets on their books that are carried at significant discounts below current market values. This difference between book value (historical cost or acquisition value) and market value of any asset, particularly for banking premises, may represent potential capital to the banking organization. These "unrealized asset values" *are not included* in the risk-based capital calculation. Examiners should take into consideration such unrecognized capital when assessing capital adequacy. Particular attention should be given to the nature of the asset, the reasonableness of its valuation, its marketability, and the likelihood of its sale.

31. The SBO would not realize any benefits in the determination of its leverage ratio since the reference assets remain on the SBO's balance sheet.

32. If the intermediary is a BO, then it could place both sets of credit-default swaps in its trading account and, if subject to the Federal Reserve's market-risk capital rules, use its general market-risk model and, if approved, specific-risk model to calculate the appropriate risk-based capital requirement. If the specific-risk model has not been approved, then the SBO would be subject to the standardized specific-risk capital charge.

33. Under this type of transaction, if a structure exposes investing BOs to the creditworthiness of a substantive issuer, for example, the SBO, then the investing BOs should assign the notes to the higher of the risk categories appropriate to the underlying reference assets or the SBO.

4060.3.5.4.2 Subordinated Debt

To be included in tier 2 capital, subordinated debt must be subordinated in right of payment to the claims of the issuer's general creditors. For bank holding companies, such debt must be subordinated to senior indebtedness. To meet this requirement, bank holding company debt must, at a minimum, be subordinated to (1) all borrowed and purchased money, (2) similar obligations arising from off-balance-sheet guarantees and direct credit substitutes, and (3) obligations associated with derivative products such as interest-rate and foreign-exchange-rate contracts, commodity contracts, and similar arrangements. (See SR-92-37.)

Subordinated debt (and intermediate-term preferred stock) must have an original weighted average maturity of at least five years to qualify as supplementary capital. The average maturity of an obligation whose principal is repayable in scheduled periodic payments (for example, a so-called serial redemption issue) is the weighted average of the maturities of all such scheduled repayments. If the holder has the option to require the issuer to redeem, repay, or repurchase the instrument before the original stated maturity, maturity is defined as the earliest possible date on which the holder can put the instrument back to the issuing banking organization. This date may be much earlier than the instrument's stated maturity date. In the last five years prior to the maturity of a limited-life instrument, the outstanding amount includable in tier 2 capital must be discounted by 20 percent a year (20 percent of the original amount less any redemptions) during the instrument's last five years before maturity. The aggregate amount of subordinated debt and intermediate-term preferred stock that may be included in tier 2 capital is limited to 50 percent of tier 1 capital (net of goodwill and other intangible assets required to be deducted in accordance with section II.B.1.b. of the risk-based capital measure). Amounts issued or outstanding in excess of this limit are not included in the risk-based capital calculation. However, examiners are to take any excess amount not included in the risk-based capital calculation into consideration when assessing the banking organization's funding and financial condition.

Consistent with long-standing Board policy, a banking organization may not repay, redeem, or repurchase a subordinated-debt issue without the prior written approval of the Federal Reserve. The terms of the debt indenture should note that such approval is required.

Close scrutiny should be given to terms that permit the holder to accelerate payment of principal upon the occurrence of certain events. The only acceleration clauses acceptable in a subordinated-debt issue included in tier 2 capital are those that are triggered by bankruptcy (in the case of a bank holding company) or receivership (in the case of a bank) (see SR-92-37).[34] Terms that permit the holder to accelerate payment of principal upon the occurrence of other events jeopardize the subordination of the debt because such terms could permit debtholders in a troubled institution to be paid out before the depositors. In addition, debt whose terms permit holders to accelerate payment of principal upon the occurrence of events other than insolvency does not meet the minimum five-year maturity requirement for debt-capital instruments. Holders of such debt have the right to put the debt back to the issuer upon the occurrence of the named events, which could happen on a date well in advance of the debt's stated maturity.

Close scrutiny should also be given to the terms of those debt issues if an event of default is defined more broadly than insolvency or a failure to pay interest or principal when due. There is a strong possibility that such terms are inconsistent with safe and sound banking practice and that, accordingly, the debt issue should not be included in capital. Concern is heightened when an event of default gives the holder the right to accelerate payment of principal or when other borrowings contain cross-default clauses. Some events of default, such as making additional borrowings in excess of a certain amount, may unduly restrict the day-to-day operations. Other events of default, such as change of control or disposal of a banking organization subsidiary, may limit the flexibility of management or supervisors to work out the problems of a troubled organization. Still other events of default, such as failure to maintain certain capital ratios or rates of return or to limit the amount of nonperforming assets or charge-offs to a certain level, may be intended to allow the debtholder to be made whole before a deteriorating banking organization becomes truly

34. A provision in bank holding company subordinated debt that permits acceleration in the event a major bank subsidiary enters into receivership would not jeopardize the issue's tier 2 capital status. A provision permitting acceleration in the event that any other type of affiliate of the issuer entered into bankruptcy or receivership would not be acceptable in a subordinated debt issue included in capital.

troubled. Debt issues that include any of these types of events of default are not truly subordinated and should not be included in capital. Likewise, bank holding companies should not include in capital debt issues that otherwise contain terms or covenants that could adversely affect the issuer's liquidity; unduly restrict management's flexibility to run the organization, particularly in times of financial difficulty; or limit the regulator's ability to resolve problem situations.

Certain terms found in subordinated debt, however, may provide protection to investors without adversely affecting the overall benefits of the instrument to the organization, and thus would be acceptable for subordinated debt to be included in capital. Among such acceptable terms would be a provision that prohibits a bank holding company from merging, consolidating, or selling substantially all of its assets unless the new entity assumes the subordinated debt. Another acceptable provision would be the inclusion as an event of default the failure to pay principal and interest on a timely basis or to make mandatory sinking fund deposits, so long as such event of default does not allow the debtholders to accelerate the repayment of principal (see SR-92-37).

Debt issues, including mandatory convertible securities, that tie interest payments to the financial condition of the borrower generally should not be included in capital. Such payments may be linked to the financial condition of an institution through various ways, such as (1) an auction-rate mechanism, which is a preset schedule mandating interest-rate increases either over the passage of time or as the credit rating of the bank holding company declines,[35] or (2) a term that raises the interest rate if payment is not made in a timely fashion. As the financial condition of a bank holding company declines, it is faced with higher and higher payments on its credit-sensitive subordinated debt at a time when it most needs to conserve its resources. Thus, credit-sensitive debt does not provide the support expected of a capital instrument to an institution whose financial condition is deteriorating; rather, the credit-sensitive feature can accelerate depletion of the organization's resources and increase the likelihood of default on the debt. While such terms may be acceptable in perpetual preferred stock qualifying for tier 2 capital, they are not acceptable in a capital debt issue because a banking organization in a deteriorating financial condition may not have the option available in equity issues of eliminating the higher payments without going into default. If a bank holding company has included in its capital subordinated debt issued by an operating or nonoperating subsidiary, it is possible that the debt is in effect secured and, thus, not includable in capital.

4060.3.5.4.3 Ineligible Collateral and Guarantees

The risk-based capital guidelines recognize collateral and guarantees in only a limited number of cases. Other types of collateral and guarantees support the asset mix of banking organizations, particularly within their loan portfolios. Such collateral or guarantees may serve to substantially improve the overall quality of loan portfolios and other credit exposures, and should be considered by examiners when they are arriving at their overall assessment of capital adequacy.

4060.3.5.4.4 Overall Asset Quality

The conclusions drawn by banking organizations from calculating their risk-based capital ratios may be significantly different from conclusions drawn by examiners. The main reason for these differences is the assessment of asset quality. Examiners must assess the capital adequacy of banking organizations, taking into account examination or inspection findings, particularly those findings regarding the severity of problem and classified assets and investment or loan portfolio concentrations, as well as the adequacy of the banking organization's allowance for loan and lease losses.

35. Although payment on debt whose interest rate increases over time may not on the surface appear to be directly linked to the financial condition of the issuing banking organization, such debt (sometimes referred to as expanding- or exploding-rate debt) has a strong potential to be credit sensitive in substance. Banking organizations whose financial condition has strengthened are more likely to be able to refinance the debt at a lower rate than that mandated by the preset increase, whereas those banking organizations whose condition has deteriorated are less likely to be able to do so. Moreover, just when these latter institutions would be in the most need of conserving capital, they would be under strong pressure to redeem the debt as an alternative to paying higher rates and therefore would accelerate depletion of their resources.

4060.3.5.4.5 Interest-Only Strips (IOs) and Principal-Only Strips (POs)

IOs and POs have highly volatile price characteristics as interest rates change and are generally not considered appropriate investments for most banking organizations. However, some sophisticated banking organizations may use IOs and POs as hedging vehicles. The Board does not want to discourage the legitimate use of IOs and POs as hedging vehicles. Examiners' assessments of capital adequacy should reflect banking organizations' appropriate use of hedging instruments, including IOs and POs. Banking organizations that have appropriately hedged their interest-rate exposure may be permitted to operate with lower levels of capital than those banking organizations that are vulnerable to interest-rate changes.

4060.3.5.4.6 Interest-Rate Risk

Examiners are to continue to scrutinize banking organizations' interest-rate risk exposure carefully and to require that organizations with undue levels of interest-rate risk strengthen their capital positions even though they may meet the minimum risk-based capital standards.

4060.3.5.4.7 Claims On, and Claims Guaranteed by, OECD Central Governments

The risk-based capital guidelines assign a zero percent risk weight to all direct claims (including securities, loans, and leases) on the central governments of the OECD-based group of countries and U.S. government agencies. Generally, the only direct claims banking organizations have on the U.S. government and its agencies are in the form of Treasury securities. Zero-coupon, that is, single-payment, Treasury securities trading under the U.S. Treasury's Separately Traded Registered Interest and Principal (STRIP) Program are assigned to the zero percent risk category. A security that has been stripped by a private-sector entity, such as a brokerage firm, is considered an obligation of that entity and, accordingly, is assigned to the 100 percent risk category.

Claims that are directly and unconditionally guaranteed by an OECD-based central government or a U.S. government agency are also assigned to the zero percent risk category. Such claims that are not unconditionally guaranteed are assigned to the 20 percent risk category. A claim is not considered to be unconditionally guaranteed by a central government if the validity of the guarantee is dependent upon some affirmative action by the holder or a third party. Generally, securities guaranteed by the U.S. government or its agencies that are actively traded in financial markets are considered to be unconditionally guaranteed. These include Government National Mortgage Association (GNMA) and Small Business Administration (SBA) securities.

As of December 30, 1992, banking organizations are permitted to assign to the zero percent risk category claims collateralized by cash on deposit in the banking organization or by OECD central governments or U.S. government agency securities for which a positive collateral margin is maintained on a daily basis, fully taking into account any change in the banking organization's exposure to the obligor or counterparty under a claim in relation to the market value of the collateral held in support of that claim. The Board is not requiring that a specific minimum margin of collateral be maintained on collateralized transactions assigned to the zero percent risk category. The Board expects that banking organizations will establish, as a part of prudent operating procedures, a minimum level of margin for these transactions based upon such factors as the volatility of the securities involved, so as to avoid unduly frequent margin calls.

A limited number of U.S. government agency–guaranteed loans are deemed to be unconditionally guaranteed and, hence, can be assigned to the zero percent risk category. These include most loans guaranteed by the Export-Import Bank (Exim Bank),[36] loans guaranteed by the U.S. Agency for International Development (AID) under its Housing Guaranty Loan Program, SBA loans subject to a secondary participation guaranty (in accordance with SBA Form 1086), and Farmers Home Administration (FmHA) loans subject to an assignment guaranty agreement in accordance with FmHA Form 449–36.

Apart from the exceptions noted in the preceding paragraph, loans guaranteed by the U.S. government or its agencies are considered conditionally guaranteed. The guaranteed portion of the loans is assigned to the 20 percent category. These loans include, but are not

36. Loans guaranteed under Exim Bank's Working Capital Guarantee Program, however, receive a 20 percent risk weight.

limited to, loans guaranteed by the Commodity Credit Corporation (CCC), the Federal Housing Administration (FHA), the Foreign Credit Insurance Association (FCIA), the Overseas Private Investment Corporation (OPIC), and the Veterans Administration (VA), and, except as indicated above, portions of loans guaranteed by the FmHA and the SBA. Loan guarantees offered by FCIA and OPIC often guarantee against political risk. However, only that portion of a loan guaranteed by FCIA or OPIC against commercial or credit risk may receive a preferential 20 percent risk weight. The portion of Government Trust Certificates issued to provide funds for the refinancing of foreign military sales loans made by the Federal Financing Bank or the Defense Security Assistance Agency that are indirectly guaranteed by the U.S. government also qualify for the 20 percent risk weight.

4060.3.6 DIFFERENCE IN APPLICATION OF THE RISK-BASED CAPITAL GUIDELINES TO BANKING ORGANIZATIONS

The capital guidelines are generally the same for state member banks and bank holding companies. Since year-end 1992, however, there has been one significant difference: the manner in which capital is defined for use in computing the risk-based capital ratio. Specifically, perpetual preferred stock is handled differently for state member banks than for bank holding companies.

4060.3.6.1 Difference in Treatment of Perpetual Preferred Stock

Bank holding companies may include unlimited amounts of *noncumulative* perpetual preferred stock in tier 1 capital and limited amounts of cumulative perpetual preferred stock. The aggregate amount of *cumulative* stock that may be included in a bank holding company's tier 1 capital is limited to one-third of the sum of core capital elements, excluding cumulative perpetual preferred stock. Any amount of *cumulative* perpetual preferred stock in excess of this limit may be included as tier 2 capital. In contrast, state member banks may include only noncumulative perpetual preferred stock in tier 1 capital.

4060.3.6.2 Perpetual Preferred Stock (Terms Relating to Tier 1 Treatment)

Given the importance of core capital, the Federal Reserve's guidelines exclude from tier 1 capital preferred stock (including auction rate preferred) in which the dividend rate is reset periodically, based in whole or in part upon the banking organization's financial condition or credit standing. Under such instruments, the obligation to pay out higher dividends in response to a deterioration in an organization's financial condition is inconsistent with the essential precept that capital should provide both strength and loss-absorption capacity to an organization during periods of adversity. Rather than paying out higher dividends, banking organizations are expected to conserve capital during such periods.

Ordinarily, fixed-rate preferred stock and traditional floating- or adjustable-rate preferred stock—where the dividend rate is based upon an independent market index that is in no way tied to the issuer's financial condition—do not raise significant supervisory concerns, especially if the adjustable-rate instrument is accompanied by reasonable spreads and cap rates. However, certain other features that have been incorporated in, or mentioned for possible inclusion in, some preferred stock issues do raise serious questions about whether these issues will truly serve as a permanent, or even long-term, source of capital. Such features include ''exploding-rate'' or similar mechanisms, whereby, after a specified period, the dividend rate automatically increases to a level that appears unreasonable or that could create substantial incentives for the issuer to redeem the instrument. Perpetual preferred stock with this type of feature could cause the banking organization to be faced with higher dividend requirements at a future date when it is experiencing financial difficulties. Such preferred stock is not generally includable in tier 1 capital.

4060.3.7 CASH REDEMPTION OF PERPETUAL PREFERRED STOCK

Under the Federal Reserve's risk-based capital guidelines, two essential characteristics of core (tier 1) capital—which comprises common stock and perpetual preferred stock—are loss-absorption capacity and stability. In addition to existing laws and regulations that pertain to the redemption or repurchase of capital securi-

ties, the Federal Reserve's risk-based capital guidelines generally provide that any bank holding company contemplating the redemption of material amounts of permanent equity instruments, including perpetual preferred stock, should receive Federal Reserve approval prior to taking such action.[37] Any perpetual preferred stock with a feature permitting redemption at the option of the issuer may qualify as capital *only if* the redemption is subject to prior approval of the Federal Reserve.

The guidelines indicate that consultation with the Federal Reserve could be unnecessary if the instrument is redeemed with the proceeds of another acceptable tier 1 instrument and the organization's capital is considered fully adequate. However, because of the need to make supervisory judgments on these conditions, as well as the objective of fostering sound capital positions, banking organizations contemplating material redemptions of core capital are generally expected to discuss these plans with their appropriate supervisory authorities, regardless of the circumstances. This has long been the expectation and practice of the Federal Reserve. Prior consultation puts the supervisory authority in a position to take appropriate action if any planned capital redemption could have an adverse impact on an organization's financial condition.

The Federal Reserve's interest in the level and composition of capital derives both from the System's general supervisory responsibilities to monitor and address any actions that could erode an organization's capital base and from the need to implement the letter and spirit of supervisory guidelines on capital adequacy. Under the Federal Reserve's guidelines, to qualify as capital an instrument may not contain or be covered by covenants, terms, or restrictions that are inconsistent with safe and sound banking practice. Moreover, perpetual preferred stock cannot contain provisions that would require future redemption of the issue, and the issuer must have the ability and legal right to defer or eliminate preferred dividends.

4060.3.7.1 Federal Reserve's Supervisory Position on Cash Redemption of Tier 1 Preferred Stock

To qualify for tier 1 treatment, redemption for cash, regardless of source, is permissible only at the issuer's option. Moreover, in view of the importance of ensuring the stability of tier 1 capital, tier 1 preferred stock instruments should also provide that cash redemption would be permitted only with the prior consent of the Federal Reserve. The Federal Reserve expects that it would usually grant such approval, when consistent with the organization's overall financial condition, if the preferred shares are redeemed with the proceeds of an acceptable tier 1 capital instrument that would maintain or strengthen the issuer's capital base. Approval could also be granted if the Federal Reserve determines that the issuer's capital position after the redemption would clearly be adequate and that the issuer's condition and circumstances warrant the reduction of a source of permanent capital.

4060.3.8 COMMON STOCK REPURCHASES AND DIVIDEND INCREASES ON COMMON STOCK

The Federal Reserve has long emphasized the importance of prudent levels of capital to the overall safety and soundness of banking organizations. In pursuit of its supervisory objective to achieve an adequate level of capitalization in banking organizations, the Federal Reserve has over time promulgated various rules, guidelines, and standards concerning capital levels and the acceptable characteristics of various capital instruments and transactions. With respect to cash redemptions of common stock, section 225.4(b)(1) of Regulation Y requires bank holding companies to give the Federal Reserve prior notice of any repurchase of common stock that would reduce total equity capital by 10 percent or more aggregated over any 12-month period. The risk-based capital guidelines further request that bank holding companies consult with the Federal Reserve prior to any material redemption of permanent equity instruments.

Because of the need for banking organizations to strengthen their capital positions generally, the Board strongly recommends that bank holding companies deemed to be experiencing financial weaknesses (or those at significant risk of developing financial weaknesses) consult with the appropriate Federal Reserve Bank prior to any cash redemption of common stock. Similarly, any bank holding company considering expansion, either through acquisitions or through new activities, is also requested to consult with

37. This general principle also applies to the redemption of limited-life capital instruments prior to their stated maturities.

the appropriate Federal Reserve Bank prior to any cash redemption of common stock. Although there may be legitimate uses of repurchased shares (for example, in ESOP transactions), this request is intended to prevent an imprudent or untimely repurchase that would have an immediate or potentially adverse impact on the financial condition of the banking organization. In general, Reserve Banks should discourage bank holding companies from repurchasing their shares if there would be an adverse effect on the capital of the organization. A similar procedure was adopted for redemptions of perpetual preferred stock (see section 4060.3.7 or SR-89-20).

Further, because the banking organizations' ability to gain access to capital markets can be further diminished by rating-agency downgrades, the Federal Reserve considers internal capital generation an important element in a banking organization's capital planning. Therefore, bank holding companies in general, but particularly those experiencing any degree of financial weakness, are requested to consult with the appropriate Federal Reserve Bank before increasing the rate of cash dividends paid on common stock, an action that reduces capital-generation rates for companies experiencing financial weakness. It is the intention of the Federal Reserve to ensure that the financial condition, future earnings prospects, and capital level of the banking organization are consistent with any proposed increase in dividends. See Regulation Y, section 225.4(b)(1) and Regulation Y, appendix A, section II.

4060.3.9 MANDATORY CONVERTIBLE DEBT SECURITIES AND PERPETUAL DEBT

Mandatory convertible debt securities are essentially subordinated debt instruments that may be converted into common or perpetual preferred stock within a specified period of time, not to exceed 12 years. To be counted as tier 2 capital, mandatory convertible securities must meet the criteria set forth below. These criteria cover the two basic types of mandatory convertible securities: equity contract notes (securities that obligate the holder to take common or perpetual preferred stock of the issuer in lieu of cash for repayment of principal) and equity commitment notes (securities that are redeemable only with the proceeds from the sale of common or perpetual preferred stock). Bank holding companies may include mandatory convertible debt securities (net of the stock dedicated to retire the issue(s)), in the form of equity contract notes or equity commitment notes as unlimited elements of tier 2 capital, provided that the applicable criteria set forth below are met (see also Regulation Y, appendix B). They are also permitted to include perpetual debt as an element of tier 2 capital. To be included as unlimited elements of tier 2 capital for bank holding companies, these instruments must meet the respective criteria set forth below (also found in Regulation Y, appendix B). The amount of mandatory convertible securities that have the proceeds of the issuance of common stock dedicated to redeem or retire them are treated as term subordinated debt subject to the specified limitation. A banking organization must receive Federal Reserve approval before redeeming (or repurchasing) mandatory convertible debt prior to maturity. The terms of the securities should note that such approval is required.

4060.3.9.1 Treatment of Debt with Dedicated Proceeds

If a bank holding company has issued common or perpetual preferred stock and dedicated the proceeds to the retirement or redemption of mandatory convertibles, the portion of mandatory convertibles covered by the dedication no longer carries a commitment to issue equity and, thus, has in effect been rendered into ordinary subordinated debt. Accordingly, the amount of the stock dedicated is netted from the amount of mandatory convertibles includable as unlimited tier 2 capital. The portion of such securities covered by dedications should be included in capital as subordinated debt, subject to amortization in the last five years of its life, and should be limited, together with other subordinated debt and intermediate-term preferred stock, to 50 percent of tier 1 capital. For example, a bank holding company has an outstanding equity contract note for $1 million and issues $300,000 of common stock, dedicating the proceeds to the retirement of the note. It would include the $300,000 of common stock in its tier 1 capital. The $700,000 of the equity contract note not covered by the dedication would be treated as an unlimited element of tier 2 capital. The $300,000 of the note covered by the dedication would be treated as subordinated debt.

4060.3.9.2 Treatment of Debt with Segregated Funds

In some cases, the indenture of a mandatory convertible debt issue may require the bank holding company to set up segregated trust funds to hold the proceeds from the sale of equity securities dedicated to pay off the principal of the mandatory convertibles at maturity. The portion of mandatory convertible securities covered by the amount of such segregated trust funds is considered secured and, thus, may not be included in capital. The maintenance of such a separate segregated fund for the redemption of mandatory convertibles exceeds the requirements of appendix B of Regulation Y. Accordingly, if a banking organization, with the agreement of the debtholders, wishes to eliminate the fund, regulatory approval normally should be given unless supervisory concerns warrant otherwise.

4060.3.9.3 Criteria Applicable to Both Types of Mandatory Convertible Securities

1. The securities must mature in 12 years or less.
2. The issuer may redeem securities prior to maturity only with the proceeds from the sale of common or perpetual preferred stock of the bank holding company. Any exception to this rule must be approved by the Federal Reserve. The securities may not be redeemed with the proceeds of another issue of mandatory convertible securities, nor may the issuer repurchase or acquire its own mandatory convertible securities for resale or reissuance.
3. Holders of the securities may not accelerate the payment of principal except in the event of bankruptcy, insolvency, or reorganization.
4. The securities must be subordinate in right of payment to all senior indebtedness of the issuer. If the proceeds of the securities are reloaned to an affiliate, the loan must be subordinated to the same degree as the original issue.
5. If an issuer intends to dedicate the proceeds of an issue of common or perpetual preferred stock to satisfy the funding requirements of an issue of mandatory convertible securities (that is, the requirement to retire or redeem the notes with the proceeds from the issuance of common or perpetual preferred stock), the issuer generally must make the dedication during the quarter in which the new common or preferred stock is issued.[38] As a general rule, if the dedication is not made within the prescribed period, then the securities issued may not at a later date be dedicated to the retirement or redemption of the mandatory convertible securities.[39]

4060.3.9.3.1 Additional Criteria Applicable to Equity Contract Notes

1. The note must contain a contractual provision (or be issued with a mandatory stock purchase contract) that requires the holder of the instrument to take the common or perpetual stock of the issuer in lieu of cash in satisfaction of the claim for principal repayment. The holder's obligation to take the common or perpetual preferred stock of the issuer may be waived if, and to the extent that, prior to the maturity date of the obligation, the issuer sells new common or perpetual preferred stock and dedicates the proceeds to the retirement or redemption of the notes. The dedication generally must be made during the quarter in which the new common or preferred stock is issued.
2. A stock purchase contract may be separated from a security only if (1) the holder of the contract provides sufficient collateral[40] to the

38. Common or perpetual preferred stock issued under dividend reinvestment plans or issued to finance acquisitions, including acquisitions of business entities, may be dedicated to the retirement or redemption of the mandatory convertible securities. Documentation certified by an authorized agent of the issuer showing the amount of common stock or perpetual preferred stock issued, the dates of issue, and amounts of such issues dedicated to the retirement or redemption of mandatory convertible securities will satisfy the dedication requirement.

39. For each dollar of common or perpetual preferred proceeds dedicated to the retirement or redemption of the notes, there is a corresponding reduction in the amount of outstanding mandatory securities that may qualify as tier 2 capital (the amount of proceeds dedicated would be included in tier 2 capital as subordinated debt subject, together with other subordinated debt, to a limit of 50 percent of tier 1 capital and to discounting of 20 percent per year during the last five years to maturity). De minimis amounts of common or perpetual stock issued under arrangements in which the amount of stock issued is not predictable, such as dividend reinvestment plans and employee stock option plans (but excluding public stock offerings and stock issued in connection with acquisitions), should be dedicated by no later than the company's fiscal year-end.

40. Collateral is defined as (1) cash or certificates of deposit; (2) U.S. government securities that will mature prior to or simultaneous with the maturity of the equity contract and that have a par or maturity value at least equal to the amount

issuer, or to an independent trustee for the benefit of the issuer, to ensure performance under the contract, and (2) the stock purchase contract requires the purchase of common or perpetual preferred stock.

4060.3.9.3.2 Additional Criteria Applicable to Equity Commitment Notes

1. The indenture or note agreement must contain the following two provisions:
   a. The proceeds of the sale of common or perpetual preferred stock will be the sole source of repayment for the notes, and the issuer must dedicate the proceeds for the purpose of repaying the notes. (Documentation, certified by an authorized agent of the issuer, showing the amount of common or perpetual preferred stock issued, the dates of issue, and amounts of such issues dedicated to the retirement or redemption of mandatory convertible securities will satisfy the dedication requirement.)
   b. By the time that one-third of the life of the securities has run, the issuer must have raised and dedicated an amount equal to one-third of the original principal of the securities. By the time that two-thirds of the life of the securities has run, the issuer must have raised and dedicated an amount equal to two-thirds of the original principal of the securities. At least 60 days prior to the maturity of the securities, the issuer must have raised and dedicated an amount equal to the entire original principal of the securities. Proceeds dedicated to redemption or retirement of the notes must come only from the sale of common or perpetual preferred stock.[41]
2. If the issuer fails to meet any of these periodic funding requirements, the Federal Reserve will immediately cease to treat the unfunded securities as tier 2 capital and will take appropriate supervisory action. In addition, failure to meet the funding requirements will be viewed as a breach of a regulatory commitment, which the Board will take into consideration when it acts on statutory applications.
3. If a security is issued by a subsidiary of a bank or bank holding company, any guarantee of the principal by that subsidiary's parent bank or bank holding company must be subordinate to the same degree as the security issued by the subsidiary and limited to repayment of the principal amount of the security at its final maturity.

4060.3.9.4 Criteria for Determining the Tier 2 Capital Status of Perpetual Debt Instruments of Bank Holding Companies

1. The instrument must be unsecured.
2. The instrument may not give the noteholder the right to demand repayment of principal except in the event of bankruptcy, insolvency, or reorganization. The instrument must provide that nonpayment of interest shall not trigger repayment of the principal of the perpetual debt note or any other obligation of the issuer, nor shall it constitute prima facie evidence of insolvency or bankruptcy.
3. The issuer shall not voluntarily redeem the debt issue without prior Federal Reserve approval, except when the debt is converted to, exchanged for, or simultaneously replaced in like amount by an issue of common or perpetual preferred stock of the issuer or the issuer's parent company.
4. If issued by a bank holding company, a bank subsidiary, or a subsidiary with substantial operations, the instrument must contain a provision that allows the issuer to defer interest payments on the perpetual debt in the event of, and at the same time as, the elimination of dividends on all outstanding common or preferred stock of the issuer (or, in the case of a guarantee by a parent company, at the same time as the elimination of the dividends of the parent company's common and preferred stock). In the case of a nonoperating subsidiary (a funding subsidiary or one formed to issue securities), the deferral of interest payments must be triggered by elimination of dividends by the parent company.
5. If issued by a bank holding company or a subsidiary with substantial operations, the instrument must convert automatically to common or perpetual preferred stock of the issuer when the issuer's retained earnings and surplus accounts become negative. If an operating subsidiary's perpetual debt is guaranteed

of the holder's obligation under the stock purchase contract; (3) standby letters of credit issued by an insured U.S. bank that is not an affiliate of the issuer; and (4) other collateral as may be designated from time to time by the Federal Reserve.

41. The funded portions of the securities will be deducted from the amount of mandatory convertible securities outstanding, but included in the amount of subordinated debt.

by its parent, the debt may convert to the shares of the issuer or parent when the issuer's or parent's retained earnings and surplus accounts become negative. If issued by a nonoperating subsidiary of a bank holding company or bank, the instrument must convert automatically to common or preferred stock of the issuer's parent when the retained earnings and surplus accounts of the issuer's parent become negative.

4060.3.10 INSPECTION OBJECTIVES

1. To determine the adequacy of capital in relation to the risks inherent in the transactions and activities of the banking organization.
2. To determine compliance with the risk-based and tier 1 leverage measures of the capital adequacy guidelines as they apply to bank holding companies (see section 4060.4 of this manual).
3. To determine if the capital management and operating policies, practices, and procedures are adequate, and whether they reflect the requirements of the capital adequacy guidelines, if applicable.
4. To evaluate the performance of the bank holding company's officers and employees in administering and controlling the capital position of the organization, including its banking and nonbanking subsidiaries.
5. To evaluate the propriety and consistency of the banking organization's present and planned level of capitalization in light of the risk-based and leverage capital measures, as required, as well as existing conditions and future plans.
6. To initiate corrective action, in conjunction with the inspection process, when policies, procedures, or capital are deficient.

4060.3.11 INSPECTION PROCEDURES

Section 4060.3.5 lists items that examiners should consider during their analysis of capital adequacy with regard to the risk-based measure. The instructions in that section are to be followed in addition to the inspection procedures listed below.

Verification of the Risk-Based Capital Ratio

NOTE: Examiners should verify that the bank holding company has adequate systems in place to compute and document its risk-based capital ratios.

1. Determine if the bank holding company is correctly reporting risk-based capital information requested on the Federal Reserve's FR Y-9C Reports of Condition and Income and supplementary schedules.
   a. If the bank holding company has consolidated assets of less than $150 million, determine whether the bank holding company risk-based capital guidelines still apply because—
      (1) the bank holding company is engaged in nonbank activity involving significant leverage (includes off-balance-sheet activities) or
      (2) the parent company has a significant amount of outstanding debt that is held by the general public.

For the qualifying components of capital

2. Determine if management is adhering to the underlying terms of any currently outstanding stock issues.
3. Review common stock to ensure that the bank holding company is in compliance with the terms of any underlying agreement(s) and to determine if more than one class exists. If more than one class exists, review the terms for any preference or nonvoting features. If the terms include such features, determine whether the class of common stock qualifies for inclusion in tier 1 capital.
4. Review any perpetual and long-term preferred stock for the following:
   a. compliance with terms of the underlying agreement(s), carefully noting—
      (1) adherence to the cumulative or noncumulative nature of the stock and
      (2) adherence to any conversion rights
   b. proper categorization as tier 1 or tier 2 for capital adequacy purposes, noting the following requirements:
      (1) Tier 1 perpetual preferred stock must have the following characteristics:
         — no maturity date
         — not redeemable at the option of the holder
         — unsecured
         — ability to absorb losses

— ability and legal right for issuer to defer or eliminate dividends
— any issuer redemption feature subject to Federal Reserve prior approval
— fixed-rate or traditional floating- or adjustable-rate
— no features that would require or create an incentive for the issuer to redeem or repurchase the instrument, such as an "exploding rate," an auction-rate pricing mechanism, or a feature that allows the stock to be converted into increasing numbers of common shares

(2) Perpetual preferred stock, includable within tier 2 capital without a sublimit, must have the characteristics listed within inspection procedure 4.b.(1) above for tier 1 perpetual preferred stock, but does not otherwise qualify for inclusion in tier 1 capital. For example, cumulative or auction-rate perpetual preferred stock, which does not qualify for tier 1 capital, may be includable in tier 2 capital.

5. Verify that minority interest in equity accounts of consolidated subsidiaries included in tier 1 capital consists of tier 1 capital elements. Determine whether any perpetual preferred stock of a subsidiary that is included in minority interest is secured by the subsidiary's assets; if so, that stock may not be included in capital.
6. Review the intermediate-term preferred stock and subordinated debt instruments included in capital for the following:
   a. compliance with terms of the underlying agreement(s), noting that subordinated debt containing one or both of the following terms may not be included in capital:
      (1) interest payments tied to the banking organization's financial condition
      (2) acceleration clauses or broad conditions of events of default that are inconsistent with safe and sound banking practices
   b. compliance with restrictions on the inclusion of such instruments in capital by verifying that the aggregate amount of both types of instruments does not exceed 50 percent of tier 1 capital (net of all goodwill) and that the portions includable in tier 2 capital possess the following characteristics:
      (1) unsecured
      (2) minimum five-year original weighted-average maturity
      (3) in the case of subordinated debt, contains terms stating that the debt (1) is not a deposit, (2) is not insured by a federal agency, (3) cannot be redeemed without prior approval from the Federal Reserve, and (4) is subordinated to depositors and general creditors
   c. appropriate amortization, if the instruments have a remaining maturity of less than five years
7. Determine, through review of minutes of the board of directors meetings, if a stock offering or subordinated debt issue is being considered. If so, determine that management is aware of the risk-based capital requirements for inclusion in capital.
8. Review any mandatory convertible debt securities for the following:
   a. compliance of the terms with the criteria set forth in Regulation Y (12 C.F.R. 225), appendix B
   b. notification in the terms of agreement that the redemption or repurchase of such securities prior to maturity is subject to prior approval from the Federal Reserve
   c. the treatment of the portions of such securities covered by the issuance of common or perpetual preferred stock dedicated to the repayment of the securities, bearing in mind the following:
      (1) The amount of the security covered by dedicated stock should be treated as subordinated debt and is subject, together with other subordinated debt and intermediate-term preferred stock, to a sublimit within tier 2 capital of 50 percent of tier 1 capital, as well as to amortization in the last five years of life.
      (2) The portion of a mandatory convertible security that is not covered by dedication qualifies for inclusion in tier 2 capital without any sublimit and without being subject to amortization in the last five years of life.
9. Verify that the transactions within the allowance for loan and lease losses have been properly accounted for during the inspection period and verify that the amount included in tier 2 capital has been limited to 1.25 percent of weighted-risk assets.

For the calculation of risk-weighted assets

10. Verify that each on- and off-balance-sheet item has been assigned to the appropriate risk category in accordance with the risk-based capital guidelines. Close attention should be paid to the underlying obligor, collateral, and guarantees, and to assignment to a risk category based upon the terms of a claim. The claim should be assigned to the risk category appropriate to the highest risk option available under the terms of the transaction. Verify that the bank holding company's documentation supports the assignment of preferential risk weights. If necessary, recalculate the value of risk-weighted assets.
11. Verify that all off-balance-sheet items have been converted properly to credit-equivalent amounts based on the risk-based capital guidelines. Close attention should be paid to the proper reporting of assets sold with recourse, financial and performance standby letters of credit, participations of off-balance-sheet transactions, and commitments.

Verification of the Tier 1 Leverage Ratio

1. Verify that the bank holding company has correctly calculated tier 1 capital in accordance with the definition of tier 1 capital for year-end 1992 as set forth in the risk-based capital guidelines.
2. Verify that the bank holding company has properly calculated average total consolidated assets.

Overall Assessment of Capital Adequacy

1. For bank holding companies that do not meet the minimum risk-based tier 1 leverage capital standard, as required, or that are otherwise considered to lack sufficient capital to support their activities, examine the capitalization plans for achieving adequate levels of capital and determine whether they are acceptable to the Federal Reserve District's management. Review and comment on these plans and any progress achieved in meeting the requirements.
2. The analysis of capital adequacy requires an evaluation of the propriety and consistency of the bank holding company's present and planned level of capitalization in light of existing conditions and future plans. In this regard, the examiner assigned to assessing capital adequacy should do the following:
   a. Using the latest Bank Holding Company Performance Report (BHCPR), analyze applicable ratios involving capital funds, comparing these ratios with those of its peer group and investigating trends or significant variations from peer-group averages.
   b. Determine that capital is sufficient to compensate for any instabilities or deficiencies in asset and liability mix and quality.
   c. Determine if the bank holding company's consolidated earnings performance enables it to fund its expansion adequately, to remain competitive in the market, and to replenish or increase its capital funds as needed.
   d. Analyze trends in the levels of debt versus equity funding, including double leverage, to determine the level of borrowing to fund equity, if any.
   e. If the reserve for loan losses is determined to be inadequate, analyze the impact of current and potential losses on the bank holding company's capital structure.
   f. Consider the impact of any management deficiencies on present and projected capital.
   g. Determine if there are any assets or contingent accounts whose quality represents an actual or potential serious weakening of capital.
   h. Consider the potential impact, should approval be given, of any proposed changes in controlling ownership on the projected capital position.
   i. Analyze assets that are considered undervalued on the balance sheet and carried at below-market values. The excess of market value over cost may represent an additional cushion to the bank holding company.
   j. Consider the cushion for absorbing losses that may be provided by any subordinated debt or intermediate-term preferred stock not included in tier 2 capital because of the 50 percent of tier 2 capital limitation or not included in capital for tier 1 leverage ratio purposes.
   k. Analyze any collateral and guarantees supporting assets that may not be taken into account for risk-based or tier 1 leverage capital purposes, and consider these in the

overall assessment of capital adequacy. This includes guarantees provided through credit-derivative transactions (see section 4060.3.5.3.9) in which the credit exposure is assigned to the risk category of the obligor of the reference asset or any collateral. For the latter, determine whether adequate capital and reserves are held against the exposures to reference assets.

l. Evaluate the consolidated asset quality of the bank holding company and determine whether it needs to strengthen its capital position based on the following:
   (1) the severity of problem and classified assets
   (2) investment or loan portfolio concentrations
   (3) the adequacy of loan-loss reserves

m. Analyze the bank holding company's management of interest-rate risk and use of hedging instruments. Determine if the bank holding company should strengthen its capital position based on undue levels of risk at any structural level within the organization. Review hedging instruments for any use of IOs and POs that may raise concerns, and management's expertise in using hedging instruments.

3. Review capital adjustments for goodwill, and other intangible assets (such as core deposit intangibles, favorable leasehold rights, organization costs, purchased trust-servicing rights, purchased investment-management relationships, purchased home-equity rights, merchant-servicing rights), that are required to be deducted from capital. An analysis of intangible assets that may be included in capital also must be performed. The analysis of these intangible assets should be performed using the following procedures:
   a. Verify the existence, the evidence of title to, and the accounting for intangible assets. Review and assess both the book values and the fair market values assigned to intangible assets, as well as the adequacy of the documentation evidencing the values, the amortization methods, and assigned amortization periods. When assessing the quality of a banking organization's intangible assets for purposes of evaluating its overall capital position, consider—
      (1) the reliability and predictability of any cash flows associated with the assets and the degree of certainty that can be achieved in periodically determining the asset's useful life and value,
      (2) the existence of an active and liquid market for the assets, and
      (3) the feasibility of selling the asset apart from the banking organization or from the bulk of its assets.
   b. Verify that intangibles are being reduced in accordance with the amortization method and that, if the carrying amount exceeds its value, the carrying value of the intangible asset is reduced accordingly, or is written off.
   c. Determine if a quarterly review of the level and quality of all intangibles is performed.
   d. Verify that goodwill and nonqualifying identifiable intangibles are deducted from tier 1 capital.
   e. Determine if the amount of mortgage-servicing rights or purchased credit-card relationships was within the established limitations on the amount that may be included in tier 1 capital.
   f. Ascertain whether the asset values of the intangible assets were reassessed during the annual audit.
4. In light of the overall capital adequacy analysis, and in accordance with the Federal Reserve's capital adequacy guidelines, determine if any appropriate supervisory action is warranted because of deficient levels of capital in relation to inherent risks of the bank holding company organization.
5. Review the following in preparation for discussion with appropriate management:
   a. all noted deficiencies regarding the capital accounts and
   b. the adequacy of present and projected capital
6. Ascertain through minutes, reports, etc., or through discussions with management how the bank holding company's future business and operational plans will affect its asset quality, capital position, and other areas of its balance sheet.
7. Prepare comments for the inspection report based on the bank holding company's capital position, including any comments on deficiencies that were observed.
8. Update the appropriate workpapers with any information that will facilitate future inspections.

4060.3.12 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Capital adequacy guidelines—BHCs:				
Measures:				
Risk-based		225, Appendix A	4–797	
Tier 1 leverage		225, Appendix D	4–798	
Bank holding company should be a source of financial and managerial strength to its subsidiaries		225.4(a)		1981 FRB 344
Policy statement on the responsibility of BHCs to act as a source of strength to their subsidiary banks			4–878	1987 FRB 441

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

4060.4.1 INTRODUCTION

On August 2, 1990, the Board issued capital leverage guidelines, effective September 10, 1990. The Board established the capital leverage ratio to be applied in conjunction with the risk-based capital guidelines. The leverage ratio is designed to complement the risk-based capital ratios when the overall capital adequacy of banking organizations is being determined.

4060.4.2 CAPITAL ADEQUACY GUIDELINES FOR BANK HOLDING COMPANIES: TIER 1 LEVERAGE MEASURE

The tier 1 leverage measure is found in appendix D of Regulation Y (12 C.F.R. 225).

4060.4.2.1 Overview of the Tier 1 Leverage Measure for Bank Holding Companies

The Board of Governors of the Federal Reserve System has adopted a minimum ratio of tier 1 capital to total assets to assist in the assessment of the capital adequacy of bank holding companies (banking organizations).[1] The principal objective of this measure is to place a constraint on the maximum degree to which a banking organization can leverage its equity capital base. It is intended to be used as a supplement to the risk-based capital measure.

The guidelines apply on a consolidated basis to bank holding companies with consolidated assets of $150 million or more. For bank holding companies with less than $150 million in consolidated assets, the guidelines will be applied on a bank-only basis unless (1) the parent bank holding company is engaged in a nonbank activity involving significant leverage[2] or (2) the parent company has a significant amount of outstanding debt that is held by the general public.

The tier 1 leverage guidelines are to be used in the inspection and supervisory process as well as in the analysis of applications acted upon by the Federal Reserve. The Board will review the guidelines from time to time and will consider the need for possible adjustments in light of any significant changes in the economy, financial markets, and banking practices.

4060.4.2.2 Tier 1 Leverage Ratio for BHCs

The Board has established a minimum level of tier 1 capital to total assets of 3 percent for strong bank holding companies (rated composite ''1'' under the BOPEC rating system for bank holding companies) and for bank holding companies that have implemented the Board's risk-based capital measure for market risk as set forth in appendixes A and E of part 225 of Regulation Y. For all other bank holding companies, the minimum ratio of tier 1 capital to total assets is 4.0 percent. Banking organizations with supervisory, financial, operational, or managerial weaknesses, as well as organizations that are anticipating or experiencing significant growth are expected to maintain capital ratios well above the minimum levels. Moreover, higher capital ratios may be required for any bank holding company if warranted by its particular circumstances or risk profile. In all cases, bank holding companies should hold capital commensurate with the level and nature of the risks, including the volume and severity of problem loans, to which they are exposed.

A banking organization's tier 1 leverage ratio is calculated by dividing its tier 1 capital (the numerator of the ratio) by its average total consolidated assets (the denominator of the ratio). The ratio will also be calculated on the basis of period-end assets, whenever necessary, on a case-by-case basis. For the purpose of this leverage ratio, the definition of tier 1 capital for year-end 1992, as set forth in the risk-based capital guidelines in appendix A of Regulation Y, will be used.[3] As a general matter, average

1. Supervisory risk-based capital ratios that relate capital to weighted-risk assets for bank holding companies are outlined in appendix A of Regulation Y.

2. A parent company that is engaged in significant off-balance-sheet activities would generally be deemed to be engaged in activities that involve significant leverage.

3. Tier 1 capital for bank holding companies includes common equity, minority interests in equity accounts of consolidated subsidiaries, qualifying noncumulative perpetual preferred stock, and qualifying cumulative perpetual preferred stock. (Cumulative perpetual preferred stock is limited to 25 percent of tier 1 capital.) In addition, as a general matter, tier 1 capital excludes goodwill; amounts of mortgage-servicing assets, nonmortgage-servicing assets, and purchased credit-card relationships that, in the aggregate, exceed 100 percent

total consolidated assets are defined as the quarterly average total assets (defined net of the allowance for loan and lease losses) reported on the banking organization's Consolidated Financial Statements (FR Y-9C Report), less goodwill; amounts of mortgage-servicing assets, nonmortgage-servicing assets, and purchased credit-card relationships that, in the aggregate, are in excess of 100 percent of tier 1 capital; amounts of nonmortgage-servicing assets and purchased credit-card relationships that, in the aggregate, are in excess of 25 percent of tier 1 capital; all other identifiable intangible assets; any investments in subsidiaries or associated companies that the Federal Reserve determines should be deducted from tier 1 capital; and deferred-tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of the limitation set forth in section II.B.4 of appendix A of Regulation Y.[4]

Whenever appropriate, including when an organization is undertaking expansion, seeking to engage in new activities, or otherwise facing unusual or abnormal risks, the Board will continue to consider the level of an individual organization's tangible tier 1 leverage ratio (after deducting all intangibles) in making an overall assessment of capital adequacy. This is consistent with the Federal Reserve's risk-based capital guidelines and long-standing Board policy and practice with regard to leverage guidelines. Organizations experiencing growth, whether internally or by acquisition, are expected to maintain strong capital positions substantially above minimum supervisory levels, without significant reliance on intangible assets.

of tier 1 capital; amounts of nonmortgage-servicing assets and purchased credit-card relationships that, in the aggregate, exceed 25 percent of tier 1 capital; all other identifiable intangible assets; and deferred-tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of certain limitations. The Federal Reserve may exclude certain investments in subsidiaries and associated companies as appropriate.

4. Deductions from tier 1 capital and other adjustments are discussed more fully in section II.B. of appendix A of Regulation Y.

Banking organizations and supervisors[1] must consider a broader range of exposures and deal with an increasingly complex array of financial instruments and activities that reflect important, but often subtle, differences in the levels of risk. Many banking organizations, especially large banking organizations and others with complex risk profiles, or those that are engaged in complex transfers of risk,[2] require formal analytical processes to identify and measure their risks and to maintain an adequate overall level of capital that is appropriate to those risks.

4060.7.1 FACTORS USED IN EVALUATING OVERALL CAPITAL ADEQUACY

Most banking organizations are currently considering several factors in evaluating their overall capital adequacy:

1. a comparison of their own capital ratios with regulatory standards and with those of industry peers
2. consideration of their—
   a. identified risk concentrations in credit and other activities;
   b. current and desired credit-agency ratings, if applicable; and
   c. the organization's historical experiences, including severe adverse events in its past.

4060.7.2 SOPHISTICATED TECHNIQUES USED IN ASSESSING CAPITAL ADEQUACY

Some more sophisticated banking organizations use risk-modeling techniques and scenario analyses to evaluate risk, but they generally have not formally incorporated these analyses into their overall assessment of capital adequacy. Those banking organizations that are using risk modeling and scenario analysis as tools to illuminate potential economic losses arising from certain types of risk are working to integrate these tools, as they apply to different risk types, into their capital adequacy assessments. The approaches and methods used vary among banking organizations, as does the degree of precision and integration. Sound practices are clearly moving toward a more quantitative, systematic, and comprehensive process for risk evaluation. Sophisticated banking organizations are also increasingly using analytical techniques developed either for pricing and performance measurement across business and product lines or for making portfolio risk-management decisions. Such techniques incorporate one or more volatility-based measures that allow for analysis of unexpected losses as well as more subjective considerations.

Regardless of the techniques used, nearly all U.S. banking organizations have found it advantageous to operate with capital levels above regulatory minimums—and above levels defined as ''well capitalized'' by regulation. High capital ratios are often not indicative of overall capital adequacy, especially for securitizations of high-quality assets and other capital arbitrage techniques. Supervisors often cannot rely solely on risk-based capital ratios as indicators of capital strength at banking organizations engaging in these types of activities.

4060.7.3 STRENGTHENING CAPITAL ADEQUACY

Banking organizations and their supervisors are increasingly emphasizing internal processes for assessing risks and for ensuring that capital, liquidity, and other financial resources are adequate in relation to an organization's overall risk profile. This increased emphasis stems from the greater scope and complexity of the banking business, particularly those activities related to ongoing financial innovation. Banking organizations therefore need to ensure that their capital is not only adequate to meet formal regulatory standards, but is also fully sufficient to support their underlying risk positions. Internal capital-management processes at large, complex banking organizations need to be significantly improved for better integration with internal risk measurement and analysis. See SR-99-18.

1. The term ''supervisors'' refers to, as an example, federal banking organization supervisors.

2. Such complex transfers of risk would include collateralized loan obligations (CLOs), credit derivatives, and credit-linked notes. For information on CLOs, see section 4353.1 in the *Trading and Capital-Markets Activities Manual*. For information on credit derivatives, see SR-96-17 or section 2129.0, and for secondary-market credit activities, SR-97-21 or section 2129.05.

4060.7.4 SUPERVISORY APPROACH TO EVALUATING CAPITAL ADEQUACY MANAGEMENT

Supervisors and examiners need to determine whether internal capital-management processes meaningfully tie the identification, monitoring, and evaluation of the risks that arise from the banking organization's business activities to the determination of its capital needs. The larger and more complex banking organizations are working to broaden their consideration of risks in assessing capital adequacy, and examiners should not immediately expect these organizations to have in place a comprehensive internal process for assessing capital adequacy. Examiners should expect, however, that such banking organizations will initiate improved capital-management efforts to do so promptly, and thereafter will make steady and meaningful progress toward that end. As these processes develop and become fully implemented, supervisors and examiners should also place increasing reliance on internal assessments of capital adequacy as an integral part of a banking organization's *capital adequacy* rating. Examiners should evaluate an organization's progress in developing these internal processes for capital adequacy assessment since the previous inspection, considering the organization's former practices and current status relative to its peers. The results of the examiner's evaluation should be recorded in the inspection report.

4060.7.5 FUNDAMENTAL ELEMENTS OF AN INTERNAL ANALYSIS OF CAPITAL ADEQUACY

A sound and effective internal analysis of capital adequacy should include the following elements:

1. *Identifying and measuring all material risks.* A disciplined risk-measurement program promotes consistency and thoroughness in assessing current and prospective risk profiles, recognizing that risks often cannot be precisely measured. The detail and sophistication of risk measurement should be appropriate for the nature of the risks posed by each of the banking organization's activities and its asset size. At a minimum, risk-measurement systems should be sufficiently comprehensive and rigorous to capture the nature and magnitude of the risks faced by the organization, while differentiating risk exposures consistently among risk categories and levels of riskiness. Controls should be in place to ensure objectivity and consistency and that all material risks—both on- and off-balance-sheet—are adequately addressed.

   Banking organizations should conduct detailed analyses to support the accuracy or appropriateness of the risk-measurement techniques used. Similarly, inputs used in risk measurement should be of good quality. Those risks not easily quantified should be evaluated through more subjective, qualitative techniques or through stress testing. Risk-profile changes should be promptly incorporated into risk measures, whether the changes are due to new products, increased volumes or changes in concentrations, the quality of the portfolio, or the overall economic environment. Such measurement *should not* be oriented to the current treatment of these transactions under risk-based capital regulations.

   When measuring such risks, banking organizations should perform comprehensive and rigorous stress tests to identify possible events or changes in markets that could have serious adverse effects in the future. Adequate consideration should be given to contingent exposures arising from loan commitments, securitization programs, and other transactions or activities that may create such exposure.
2. *Relating capital to the level of risk.* The amount of capital held should reflect not only the measured amount of risk but also an additional amount to account for potential uncertainties in risk measurement. A banking organization's capital should reflect the perceived level of precision in the risk measures used, the potential volatility of exposures, and the relative importance of the activities producing the risk. Capital levels should also reflect the fact that historical correlation among exposures can change rapidly.

   Banking organizations should be able to demonstrate that their approach to relating capital to risk is conceptually sound and that outputs and results are reasonable.[3] Sensi-

3. One credible method for assessing capital adequacy would be for a banking organization to consider itself adequately capitalized if it meets a reasonable and objectively determined standard of financial health, tempered by sound judgment—such as a target public-agency debt rating or even a statistically measured maximum probability of becoming insolvent over a given time horizon. In effect, this latter method is the foundation of the Basle Accord's treatment of capital requirements for market and foreign-exchange risk.

tivity analysis of key inputs and peer analysis can be used in assessing an organization's approach to relating its capital to risk.

3. *Stating explicit capital adequacy goals with respect to risk.* Explicit goals need to be established for capitalization as a standard for evaluating the banking organization's capital adequacy with respect to risk. Its target capital levels might reflect the desired level of risk coverage or, alternatively, a desired credit rating that reflects a desired degree of creditworthiness and thus access to funding sources. These goals should be reviewed and approved by the board of directors. Because risk profiles and goals may differ across banking organizations, the chosen target levels of capital may differ significantly from one organization to another. Moreover, banking organizations should evaluate whether long-run capital targets might differ from short-run goals, based on current and planned changes in risk profiles and the recognition that accommodating new capital needs can require significant lead time.

   In addition, capital goals and the monitoring of performance against those goals should be integrated with the methodology used to identify the adequacy of the allowance for credit losses (the allowance). Both the allowance and capital represent the ability to absorb losses; however, an insufficiently clear distinction between their respective roles can distort the analysis of their adequacy. For example, a banking organization's internal standard of *capital* adequacy for credit risk could reflect the desire that capital absorb ''unexpected losses''—that is, some level of potential losses above that level already estimated as being inherent in the current portfolio and reflected in the allowance.[4] If the allowance is not maintained at the high end of the range of estimated credit losses, the banking organization would require more capital than would otherwise be necessary to maintain its overall desired capacity to absorb potential losses. Failure to recognize this relationship could lead to overestimating the strength of its capital position.

4. *Assessing conformity to the banking organization's stated objectives.* A banking organization's target level and composition of capital, along with the process for setting and monitoring such targets, should be periodically reviewed and approved by its board of directors.

4060.7.6 RISKS ADDRESSED IN A SOUND INTERNAL ANALYSIS OF CAPITAL ADEQUACY

Sound internal risk-measurement and capital-assessment processes should address the full range of risks faced by the banking organization. The capital regulations of the Federal Reserve (and the other U.S. banking agencies) refer to many specific factors and other risks that banking organizations should consider in assessing capital adequacy.[5]

Credit risk. Internal credit-risk-rating systems are vital to measuring and managing credit risk at large banking organizations. A large banking organization's internal ratings system should be adequate to support the identification and measurement of risk for its lending activities and be adequately integrated into its overall analysis of capital adequacy (see SR-98-25). Well-structured credit-risk-rating systems should reflect implicit, if not explicit, judgments of loss probabilities or expected loss, and should be supported where possible by quantitative analysis. Definitions of risk ratings should be sufficiently detailed and descriptive, consistently applied, and reviewed throughout the organization.[6]

Banking organizations should also take full account of credit risk arising from securitization and other secondary-market credit activities, including credit derivatives (see SR-97-21).[7] Maintaining detailed and comprehensive credit-risk measures is most necessary at banking orga-

4. In March 1999, the banking agencies and the Securities and Exchange Commission issued a joint interagency letter to financial institutions stressing that depository institutions should have prudent and conservative allowances that fall within an acceptable range of estimated losses. The Federal Reserve has issued additional guidance on credit-loss allowances to supervisors and bankers. See SR-99-13 and SR-99-22.

5. See 12 CFR 208, appendix A (overview), for state member institutions and 12 CFR 225, appendix A (overview), for bank holding companies.

6. SR-98-25 and section 2122.0 discuss the need for banking organizations to have sufficiently detailed, consistent, and accurate risk ratings for all loans, not only for criticized or problem credits. This guidance also describes an emerging sound practice of incorporating such ratings information into internal capital- allocation frameworks, recognizing that riskier assets require higher capital levels.

7. Secondary-market credit activities generally include loan syndications, loan sales and participations, credit derivatives, and asset securitizations, as well as the provision of credit enhancements and liquidity facilities to support such transactions. See SR-97-21 and section 2129.05.

nizations that conduct asset securitization programs, as these activities have the potential to greatly change—and reduce the transparency of—the risk profile of credit portfolios.[8] Because the current capital standard treats most loans alike, banking organizations have incentives to reduce their regulatory capital requirements by securitizing or otherwise selling lower-risk assets, while increasing the average level of remaining credit risk through devices like first-loss positions and contingent exposure. Thus, it is important that banking organizations are able to assess their remaining risks and hold appropriate levels of capital and allowances. Banking organizations are at the frontier of financial innovation, and they should also be at the frontier of risk measurement and internal capital allocation.

Market risk. The regulatory capital standard for market risk is based largely on a banking organization's own measure of value-at-risk (VaR). The market-risk standard emphasizes the importance of stress testing as a critical complement to a VaR-based calculation in evaluating the adequacy of capital to support the trading function.

Interest-rate risk. The interest-rate risk inherent in a banking organization's activities should also be closely monitored. The banking agencies have emphasized that banking organizations should carefully assess the risk to the economic value of their capital from adverse changes in interest rates. The Joint Agency Policy Statement on Interest-Rate Risk (see SR-96-13) stresses the importance of (1) assessing interest-rate risk in relation to the economic value of a banking organization's capital and (2) sound practices in selecting appropriate interest-rate scenarios to be applied for capital adequacy purposes.

Operational and other risks. Many banking organizations view operational risk—often viewed as any risk not categorized as credit or market risk—as being second in significance only to credit risk. Although operational risk does not easily lend itself to quantitative measurement, it can result in substantial costs through error, fraud, or other performance problems. The growing dependence of banking organizations on information technology emphasizes one aspect of the need to identify and control this risk.

4060.7.7 CAPITAL COMPOSITION

The analysis of capital adequacy should couple (1) a rigorous assessment of the particular measured and unmeasured risks the banking organization faces with (2) consideration of the capacity of its paid-in equity and other capital instruments to absorb economic losses. The Board's long-standing view is that common equity (that is, common stock and surplus and retained earnings) should be the dominant component of a banking organization's capital structure and that organizations should avoid undue reliance on capital elements that do not form common equity.[9] Common equity allows an organization to absorb losses on an ongoing basis and is permanently available for this purpose. Further, this element of capital best allows organizations to conserve resources when they are under stress because it provides full discretion as to the amount and timing of dividends and other distributions. Consequently, common equity is the basis on which most market judgments of capital adequacy are made.

Consideration of the capacity of a banking organization's capital structure to absorb losses should also take into account how that structure could be affected by changes in performance. For example, a banking organization experiencing a net operating loss—perhaps due to realization of unexpected losses—will not only face a reduction in its retained earnings, but also possible constraints on its access to capital markets. These constraints could be exacerbated if detrimental conversion options are exercised. A decrease in common equity, the key element of tier 1 capital, may have further unfavorable implications for a banking organization's regulatory capital position. The eligible amounts of most types of tier 1 preferred stock and tier 2 or tier 3[10] capital elements may be reduced because

8. SR-97-21 and section 2129.05 state that such changes have the effect of distorting portfolios that were previously ''balanced'' in terms of credit risk. The term ''balanced'' refers to the overall weighted mix of risks assumed in a loan portfolio by the current regulatory risk-based capital standard. This standard, for example, effectively treats the commercial loan portfolios of all banks as having ''typical'' levels of risk.

9. The Basle Committee on Banking Supervision affirmed this view in an October 1998 release, which stated that common shareholders' funds are the key element of capital. It also suggested that, to protect the integrity of an organization's tier 1 capital and its common equity base, innovative instruments included in tier 1 capital generally should be limited to 15 percent of total tier 1.

10. For the definition of tier 3 capital, see market-risk measure, Regulation Y (12 C.F.R. 225), appendix E, section 2(d).

current capital requirements limit the amount of these elements to a maximum percentage of tier 1 capital. Such adverse magnification effects could be further accentuated if adverse events take place at critical junctures for raising or maintaining capital (for example, as limited-life capital instruments are approaching maturity or new capital instruments are being issued).

4060.7.8 EXAMINER REVIEW OF INTERNAL ANALYSIS OF CAPITAL ADEQUACY

During inspections and supervisory contacts at large, complex banking organizations (LCBOs), examiners should review internal capital-assessment processes, as well as the adequacy of the organizations' capital and their compliance with regulatory capital standards. Such reviews should assess the degree to which an organization has in place, or is making progress toward implementing, a sound internal process to assess capital adequacy. Examiners should briefly describe in the inspection report the approach and internal processes that are used by the banking organization to assess capital adequacy with respect to its risks. Examiners should then document their evaluation of the adequacy and appropriateness of these processes for the size and complexity of the organization and its risk profile. Examiners should also report their assessment of the quality and timing of the organization's plans to develop and enhance its processes for evaluating capital adequacy with respect to risk. Significant deficiencies and inadequate progress in developing and maintaining capital-assessment procedures should also be noted. Examiners should discuss plans for correcting any deficiency with the organization's directors and management and, as appropriate, initiate supervisory action.

In all cases, the examiner's evaluation of the internal processes for an organization's capital adequacy review should be considered in determining its supervisory rating for management. Examiners should expect those organizations that are already active in complex activities involving the transfer of risk, such as securitization and related activities, to have sound internal processes for assessing capital adequacy in place immediately as a fundamental element of safe and sound operation.

Beyond its consideration in evaluating management, the examiner's review should also become, over time, an integral element of assessing and assigning a supervisory rating for capital adequacy. The banking organization should be developing appropriate processes for establishing capital targets and analyzing its capital adequacy. If these internal assessments suggest that capital levels appear to be insufficient to support the risks taken by the banking organization, examiners should note this finding in the inspection report; discuss plans for correcting this insufficiency with the banking organization's directors and management; and, as appropriate, initiate follow-up supervisory actions.

4060.7.8.1 Adequacy of Risk Measurement and Risk Coverage

Examiners should assess the degree to which internal targets and processes incorporate the full range of material risks faced by the banking organization. They should also assess the adequacy of risk measures used in assessing internal capital adequacy, and the extent to which these risk measures are also used operationally in setting limits, evaluating business-line performance, and evaluating and controlling risk. Measurement systems that are in place but are not integral to the banking organization's risk management should be viewed with some skepticism. Examiners should review whether an organization's approach treats similar risks across products and/or business lines consistently, and whether changes in its risk profile are timely. Finally, examiners should consider the results of sensitivity analyses and stress tests conducted by the banking organization and how these results relate to its capital plans.

4060.7.8.2 Relating Capital to the Level of Risk

In addition to complying with regulatory capital ratios, banking organizations should be able to demonstrate through internal analysis that their capital levels and composition are adequate to support the risks they face, and that these levels are properly monitored and reviewed by directors. Examiners should review this analysis, including the target levels of capital chosen, to determine whether it is sufficiently comprehensive and relevant to the current operating environment. Examiners should also consider the extent to which the banking organization has provided for unexpected events in setting its capital levels. The analysis should cover a suffi-

ciently wide range of external conditions and scenarios, and the sophistication of techniques and stress tests used should be commensurate with the banking organization's activities. Consideration of such conditions and scenarios should take appropriate account of the possibility that adverse events may have disproportionate effects on overall capital levels, such as the effect of tier 1 limitations, adverse capital-market responses, and other magnification effects. Finally, supervisors should consider the quality of the banking organization's management information reporting and systems, the manner in which business risks and activities are aggregated, and management's record in responding to emerging or changing risks.

Finally, when performing their review, supervisors and examiners should be careful to distinguish between a comprehensive process that seeks to identify a banking organization's capital requirements on the basis of measured economic risk, and one that focuses only narrowly on the calculation and use of allocated capital or "economic value added" (EVA) for individual products or business lines for internal profitability analysis. This latter approach, which measures the amount by which operations or projects return more or less than their cost of capital, can be important to an organization in targeting activities for future growth or cutbacks. It requires, however, that the organization first determine—by some method—the amount of capital necessary for each activity or business line. The process for determining the necessary capital should not be confused with management's related efforts to measure relative returns of the firm or of individual business lines, given an amount of capital already invested or allocated. Such EVA approaches often do not meaningfully aggregate the allocated capital across business lines and risk types as a tool for evaluating the banking organization's overall capital adequacy.

4060.7.9 INSPECTION OBJECTIVES

1. To integrate an assessment of capital adequacy with a comprehensive analysis of existing risk.
2. To determine whether internal capital-management processes meaningfully tie the identification, monitoring, and evaluation of the banking organization's risks, arising from its business activities, to the determination of its capital needs.
3. To evaluate a banking organization's progress in developing a comprehensive internal process for assessing capital adequacy, and to document that progress in the inspection report.
4. To place greater reliance on internal assessments of the banking organization's processes that are used to evaluate capital adequacy, and to incorporate those assessments into a supervisory rating for management and capital adequacy.
5. For banking organizations involved in complex activities such as securitization, other secondary-market activities (including credit derivatives), or other complex transfers of risk, to determine and report whether a sound, fundamental internal process for the analysis of capital adequacy currently exists.
6. To discuss with the board of directors and management any insufficiency in capital adequacy management, recognizing the risks taken, and to reach agreements for corrective action.

4060.7.10 INSPECTION PROCEDURES

Internal Capital Assessment

1. Review the banking organization's internal capital-assessment processes as well as its capital adequacy and compliance with regulatory capital standards.
2. Briefly describe in the inspection report the approach and internal processes that are used to assess capital adequacy with respect to the banking organization's risks.
   a. Evaluate and document an assessment of the adequacy and appropriateness of these internal processes (including the extent of their contribution to the assignment of a management supervisory rating). Consider the size and complexity of the banking organization with respect to the quality and timing of its plans to develop and enhance its processes for evaluating capital adequacy with respect to risk.
   b. If the banking organization is already involved in complex activities involving the transfer of risk, such as securitization and related activities, ascertain whether sound internal processes currently exist for evaluating capital adequacy.
   c. If the internal assessments described above suggest that capital levels appear to be insufficient to support the risks taken, dis-

cuss plans for correcting this insufficiency with the directors and management, and note these finding(s) in the inspection report and initiate follow-up supervisory action(s).

Measurement and Risk Coverage

1. Determine the degree to which internal targets and processes incorporate the full range of material risks faced by the banking organization.
   a. Evaluate the adequacy of risk measures used in assessing internal capital adequacy.
   b. Assess the extent to which these risk measures are used operationally in setting limits, evaluating business-line performance, and evaluating and controlling risk.
2. Ascertain whether the banking organization's approach treats similar risks across products and/or business lines consistently, and whether changes in the risk profile are fully reflected in a timely manner.
3. Evaluate the results of sensitivity analyses and stress tests conducted by the banking organization, and determine how these results relate to its capital plans.

Relating Capital to the Level of Risk

1. Determine whether the banking organization can demonstrate through internal analysis that its target capital levels and composition are adequate to support present risks, and whether these levels are properly monitored and reviewed by the directors. Decide if the internal analysis is sufficiently comprehensive and relevant to the current operating environment.
2. Ascertain if the banking organization has provided for unexpected events in setting its capital levels.
   a. Evaluate whether the analysis covers a sufficiently wide range of external conditions and scenarios.
   b. Determine if the sophistication of techniques and stress tests used are commensurate with the banking organization's activities.
3. Evaluate the quality of the banking organization's management information reporting and systems, the manner in which business risks and activities are aggregated, and management's record in responding to emerging or changing risks.
4. Establish whether the internal capital-analysis plan is—
   a. a comprehensive process that seeks to identify the banking organization's capital requirements on the basis of measured economic risk; or
   b. a narrow process that focuses only on the calculation and use of allocated capital or "economic value added" (EVA) for individual products or business lines for internal profitability analysis.

The bank holding company rating system is a management information and supervisory tool which defines the condition of bank holding companies in a systematic way. The system adopts the ''component'' approach by: (1) evaluating the financial condition and risk characteristics of each major component of the bank holding company; (2) assessing the important interrelationships among the components; and (3) analyzing the strength and significance of key consolidated financial and operating performance characteristics. This approach is particularly appropriate since holding companies are to be a source of financial and managerial strength to their bank subsidiaries.

In order to arrive at an overall assessment of financial condition, the following elements of the bank holding company are evaluated and rated on a scale of one through five in descending order of performance quality:

1. Bank Subsidiaries
2. Other (Nonbank) Subsidiaries
3. Parent Company
4. Earnings—Consolidated
5. Capital Adequacy—Consolidated

The first three elements of the rating, i.e., the bank, other subsidiaries, and parent company, reflect the contribution of each to the fundamental financial soundness of the holding company. The rating of consolidated earnings and capital recognizes the importance that regulators place on these factors and their crucial role in maintaining the financial strength and supporting the risk characteristics of the entire organization.

The ability and competence of holding company management bear importantly on every aspect of holding company operations and, consequently, are included as a major factor in the evaluation of each of the five principal elements of the bank holding company rating, as well as in the assignment of an overall holding company rating.

In addition to the individual elements described above, each company is accorded an overall or composite rating, comprising both a financial and managerial component. The financial composite rating is predicated upon an overall evaluation of the ratings of each of the five principal elements of the holding company's operations as defined above. The financial composite rating is also based upon a scale of one through five in descending order of performance quality. Thus, one represents the lowest and five the highest degree of supervisory concern. The managerial composite is predicated upon a comprehensive evaluation of holding company management as reflected in the conduct of the affairs of the bank and nonbank subsidiaries and the parent company. The managerial composite is indicated by the assignment of ''S'', ''F'', or ''U'' for, respectively, management that is found to be satisfactory, fair or unsatisfactory.

The complete rating represents a summary evaluation of the bank holding company in the form of a rating ''fraction.'' The ''numerator'' reflects the condition of the principal components of the holding company and assessments of certain key consolidated financial and operating factors. The ''denominator'' represents the composite rating, as defined in greater detail below, including both its financial and managerial components. While the elements in the ''numerator'' represent the essential foundation upon which the composite rating is based, the composite need not reflect a simple arithmetic mean or rigid formula weighting of the individual performance dimensions. Any kind of formula could be misleading and inappropriate. Rather, the composite should reflect the rater's judgment of the overall condition of the bank holding company based upon his knowledge and experience with the company. Thus, the complete rating is displayed as follows:

$$\frac{\text{B–O–P–E–C}}{\text{F–M}}$$

The bank holding company rating system parallels the uniform interagency bank rating system to some degree by utilizing similar rating scales and performance definitions to evaluate both the individual elements and the summary or overall condition of the holding company. This framework will provide for consistency and facilitate the adoption and use of the holding company rating system. The rating system is also sufficiently flexible to allow for appropriate differences in appraising shell bank holding companies.

Since shell bank holding companies comprise the majority of supervised companies, and involve a substantial volume of banking assets, they must also be addressed by the rating system. The procedure would be similar to that so far described; however, the other (nonbank) subsidiaries, consolidated earnings, and consolidated capital ratings would be assigned a ''0'' rating since these components have little relevance for

the shell company. This leaves the parent (with emphasis on cash flow and debt servicing ability), bank and composite (both financial and managerial) as remaining elements of the shell bank holding company rating.

For purposes of the rating, shell companies shall be defined as bank holding companies that have total consolidated assets less than $150 million *and* that have no significant nonbank subsidiaries. Companies with consolidated assets of $150 million or more are obliged to file consolidated FR Y–9 C and FR Y–9 LP reports and, therefore, are to be accorded a complete rating regardless of the existence of nonbank subsidiaries. (Companies of $150 million or more in assets with no significant nonbank subsidiaries would be assigned a ''0'' for the ''other subsidiary'' component of the rating.) Nonshell companies under $150 million in consolidated assets with significant nonbank assets should be assigned a rating that includes a component for the nonbank subsidiaries. Thus, such companies' ratings will include the bank, other nonbank, and parent components, but may exclude consolidated earnings and capital ratings since the needed figures may not be available. In order to avoid confusion as to which components have been rated, and to provide for computer processing, whenever a component is not rated, a ''0'' should be assigned (i.e., 2–0–3–0–0).

As this scheme suggests, elements are to be rated whenever they are relevant for a particular company. In practice, this means that: (1) all companies with $150 million or more in consolidated assets should be given a complete rating; (2) shell companies as defined above should be accorded a rating for the bank and parent components and both composites; and (3) nonshell companies under $150 million in assets *with* significant nonbank operating subsidiaries should receive a rating that includes a nonbank component. Ratings of consolidated earnings and capital may also be included for such companies at the discretion of the examiner if the figures are available or if deemed necessary to accurately reflect overall condition. Of course, a managerial composite rating should be provided for all companies.

4070.0.1 FINANCIAL COMPOSITE RATING

The five composite ratings are defined and distinguished as follows:

1. Composite 1

Bank holding companies in this group are sound in almost every respect; any negative findings are basically of a minor nature and can be handled in a routine manner. Such holding companies and their subsidiaries are resistant to external economic and financial disturbances and readily generate cash flow which is more than adequate to service their debt and other fixed obligations with no harm to subsidiaries.

2. Composite 2

Bank holding companies in this group are also fundamentally sound but may reflect modest weaknesses correctable in the normal course of business. Such holding companies and their subsidiaries generate cash flow which is adequate to service their obligations; however, areas of weakness could develop into conditions of greater concern. To the extent that the minor adjustments are handled in the normal course of business, the supervisory response is limited.

3. Composite 3

Bank holding companies in this group exhibit a combination of weaknesses ranging from fair to moderately severe. Such holding companies and their subsidiaries are less resistant to the onset of adverse business conditions and could likely deteriorate if concerted action is not effective in correcting the areas of weakness. The company's cash flow is sufficient to meet immediate obligations but, unless action is taken to correct weaknesses, parent cash flow needs could adversely affect the financial condition of the subsidiaries. Consequently, such bank holding companies are vulnerable and require more than normal supervision. Overall strength and financial capacity, however, are still such as to pose only a remote threat to the viability of the company.

4. Composite 4

Bank holding companies and their subsidiaries in this group have an immoderate volume of asset weaknesses, or a combination of other conditions that are less than satisfactory. An additional weakness may be that the holding company's cash flow needs are met only by upstreaming imprudent dividends and/or fees from its subsidiaries. Unless prompt action is taken to correct these conditions, they could impair future viability. Bank holding companies in this category require close supervisory attention and increased financial surveillance.

5. Composite 5

The volume and character of the weaknesses of bank holding companies in this category are so critical as to require urgent aid from shareholders or other sources to prevent insolvency. The imminent inability of such compa-

nies to service their fixed obligations and/or prevent capital depletion from severe operating losses places their viability seriously in doubt. Such companies require immediate corrective action and constant supervisory attention.

4070.0.2 MANAGEMENT COMPOSITE RATING

The management rating is intended to reflect an overall evaluation of the capabilities and competence of the management of the parent company and senior management of the bank(s) and nonbank subsidiaries. The assessment of management must take place within the context of the situation and circumstances surrounding the individual holding company under evaluation. Since business complexities and operating problems vary with the size and type of holding company activity, management that is competent to effectively discharge responsibilities under one set of conditions may be less competent as these conditions change. Management performance must be evaluated against virtually all factors necessary to operate the holding company's activities soundly and prudently. In addition to objective operating results, important subjective considerations in assessing management performance include the following:

1. technical competence, leadership, administrative ability, and management depth and succession
2. knowledge of and compliance with the Bank Holding Company Act and related regulations, and all other relevant laws and regulations
3. history of serving the banking needs of the community
4. ability to plan and respond to changing circumstances
5. ability of parent management to monitor and direct subsidiary operations to ensure prudent operation and compliance with established holding company policies
6. adequacy and scope of internal audit systems and controls, and evaluation of them as contained in audit reports
7. attitude toward risk as indicated by any undue reliance on resources of subsidiary bank(s) to support nonbank activities

A rating of satisfactory (S) is indicative of management that is fully effective with respect to almost all factors and that exhibits a responsiveness and ability to cope successfully with existing and foreseeable problems that may arise in the conduct of the parent's or subsidiaries' affairs. Management rated satisfactory is knowledgeable concerning relevant laws and regulations, and has demonstrated an understanding of the need to insulate the subsidiary bank(s) from any undue risk associated with nonbank activities. A rating of fair (F) reflects performance that is lacking in some measure of ability that would be desirable to meet responsibilities necessitated by various situations which management must address. Performance is characterized by modest talent when above-average abilities are called for or by distinctly below-average talent for the type and size of organization. Thus, management's responsiveness or ability to correct less than satisfactory conditions may be lacking. Moreover, such management may reflect a less than satisfactory understanding of relevant holding company laws and regulations. A rating of unsatisfactory (U) is indicative of management that is demonstrably inferior or incompetent in relation to the responsibilities or problems it faces. This rating may also be indicative of management that has demonstrated an inclination to subject the subsidiary bank(s) to excessive or unwarranted risk as a result of the activities of the nonbank subsidiaries. In these cases, problems resulting from management weakness are of such severity that management must be strengthened or replaced before sound conditions can be brought about.

4070.0.3 PERFORMANCE EVALUATION

The five components of holding company operations (bank subsidiaries, nonbank subsidiaries, parent only, consolidated earnings, and capital) are to be evaluated on a scale of one to five. The following is a description of the gradations to be utilized in assigning performance ratings:

1. Rating No. 1 indicates strong performance. It is the highest rating and is indicative of performance that is significantly higher than average and that obviates the need for supervisory concern.

2. Rating No. 2 reflects satisfactory performance. It reflects performance that is average or above; it includes performance that adequately provides for the safe and sound operation of the bank holding company and its subsidiaries.

3. Rating No. 3 represents performance that is flawed to some degree; as such, it is considered fair. It is neither satisfactory nor marginal but is characterized by performance of below-average quality. Such performance requires man-

agement attention due to the distinct possibility of further deterioration.

4. Rating No. 4 represents marginal performance which is significantly below average; if left unchecked, such performance might evolve into weaknesses or conditions that could threaten the viability of the institution.

5. Rating No. 5 is considered unsatisfactory. It is the lowest rating and is indicative of performance that is critically deficient and in need of immediate remedial attention. Such performance by itself, or in combination with other weaknesses, could threaten the viability of the institution.

4070.0.4 BANK CONDITION

The bank condition component is intended to reflect the overall condition of the banking subsidiary or subsidiaries. For this purpose, use is made of the subsidiary bank CAMELS composite rating(s). In the case of multibank companies, each bank's composite rating should be weighted according to its asset size to arrive at an average bank composite rating. Weighting implies that, in most cases, the bank condition component in the holding company rating system will usually reflect the lead bank's composite according to the Uniform Financial Institutions Rating System (CAMELS).

To highlight the presence of one or more problem bank(s) in a multibank holding company whose bank condition component, based on weighted averages, might not otherwise reveal their presence (that is, bank condition ratings of 1, 2, or 3), a problem identifier (P) would be attached to the bank condition rating (for example, 1P, 2P, 3P). Thus, 2P would indicate that, while on balance the banking subsidiaries are rated satisfactory, there exists a problem bank (composite 4 or 5) among the banking subsidiaries. The problem identifier is unnecessary when the bank condition component is rated 4 or 5. Although the bank condition component is a weighted average, it can be adjusted for subjective, judgmental reasons at the discretion of the rater.

4070.0.5 OTHER (NONBANK) SUBSIDIARIES

The other subsidiaries rating is designed to assess the condition of the nonbank subsidiaries in the context of their overall impact on the financial condition of the holding company and the subsidiary bank(s). In so doing, emphasis must be placed on the asset quality of credit-extending subsidiaries and the profitability and operating soundness of non-credit-extending subsidiaries. The evaluation of other subsidiaries should concentrate on the quality and condition of nonbank assets defined as—

1. the underlying assets of credit-extending nonbank subsidiaries; and

2. the parent's investment in and advances to non-credit-extending subsidiaries.

The inclusion of No. 2 in the definition acknowledges the fact that poorly run servicing or other non-credit-extending subsidiaries can pose significant risk exposure to the holding company, which should be explicitly reflected in the rating. Such exposure might result, for example, from operating losses or off-balance-sheet items such as guarantees. In many cases, since non-credit-extending subsidiaries are not heavy borrowers from external sources, the parent's investments in and advances to such companies will serve as a proxy for the magnitude of their operations. The degree of risk associated with the non-credit-extending subsidiaries may be quantified for the purpose of analyzing nonbank asset quality by classifying the parent's investments in and advances to such subsidiaries if the financial condition of the subsidiaries or the characteristics of their assets permits a meaningful conventional asset classification. This might be the case, for instance, if the subsidiaries' historical earnings record has not, in the examiner's judgment, adequately accounted for the development of clearly identifiable loss potential associated with the entity's operations. If a conventional classification of the investments in or advances to the non-credit-extending subsidiaries is not considered suitable, the examiner should identify and fully analyze the risk exposure posed by the non-credit-extending subsidiaries in the inspection report, specifically in the open section narrative analysis of financial condition. Any classifications or analysis of the parent's investments in and advances to non-credit-extending subsidiaries should be presented in the open section of the report and considered in arriving at the nonbank subsidiary component of the rating system. In assessing the investment in or advance to a non-credit-extending subsidiary, the analysis should parallel that for any asset appraisal, with particular attention given to the subsidiary's purpose and operating efficiency, management reporting procedures, and profitability. Also, foreign subsidiaries should be assessed in a

manner similar to that for the company's domestic nonbank investments.

The degree of risk associated with credit-extending subsidiaries is determined by the classification of the underlying assets of the subsidiaries. The severity of both problem investments and classified assets should be reflected by using the following weights: 100 percent of ''loss,'' 50 percent of ''doubtful,'' and 20 percent of ''substandard.''

A major step in rating nonbank activities is first to appraise their significance to the company's overall financial performance. The appraisal should focus on the potential loss exposure these activities pose to the bank holding company. One way of estimating this exposure is to compare total nonbank assets as defined above, plus any additional exposure not reflected in total assets, to total consolidated capital. As a general rule, other subsidiaries should be rated whenever nonbank assets exceed 5 percent of consolidated capital or $10 million, whichever is lower. If this condition is not met, a ''0'' should be entered for the rating of other subsidiaries. Other subsidiary assets that do not meet the significance conditions may be rated if, in the opinion of the rater, not to do so would significantly misrepresent the condition of the holding company.

When a rating is assigned to nonbank assets, considerations should include—

1. the relationship of problem investments in and advances to non-credit-extending subsidiaries plus classified assets in the credit-extending nonbank subsidiaries to total nonbank assets as defined above;

2. the relationship of problem investments and advances plus classified assets to the sum of parent company and nonbank valuation reserves and ex-bank consolidated equity capital, or to any more appropriate or refined capital index or measure, if warranted;

3. the ability of nonbank management to supervise and exercise overall control over nonbank subsidiary operations in order to ensure prudent operation, sound asset administration, and compliance with established holding company policies and relevant laws and regulations; and

4. management attitudes toward risk as indicated by any undue reliance on resources of affiliated bank(s) to support nonbank subsidiaries.

The specific delineation of the above considerations is not meant to preclude taking into account other relevant factors such as profitability, operating efficiency, management controls, reporting procedures, and any other relevant factors that, in the judgment of the rater, are necessary to assess accurately the condition of the nonbank subsidiaries.

An asset quality rating of 1 obviates the need for supervisory concern due to the existence of sound, well-managed nonbank operations, investments, and loan portfolios. A 2 rating may indicate the existence of some asset problems or other minor operational weaknesses, but still represents fundamentally sound, well-managed asset conditions warranting minimal supervisory concern. A 2 may also reflect asset problems that are clearly of little supervisory concern, given their unlikely impact on the bank(s) and the size and overall strength of the holding company. Problems associated with a 2 rating can readily be resolved in the normal course of business. A 3 rating represents the existence of deficiencies such as a significant upward trend in classifications, management control weaknesses, or other problems that, if left unchecked, could cause substantial deterioration and have an adverse impact on the banking subsidiaries. A 4 rating represents an increased need for supervisory surveillance and concern due to any combination of poor operations, weak management, or severe asset problems that are currently having a serious impact on the holding company or the banking subsidiaries. A 5 rating applies to a critical level of nonbank problems.

4070.0.6 PARENT COMPANY

The parent company rating reflects the financial condition of the parent company by focusing on (1) its ability to readily service its debt and other fixed obligations and (2) the quality of direct parent credit extensions to entities that are not subsidiaries of the holding company. (Investments in and advances to holding company subsidiaries are treated above in connection with the evaluation of the nonbank subsidiaries.)

In analyzing the parent company, consideration should be given to its ability to generate adequate cash flow from its ongoing operations and the liquidity of its assets. Potential sources of cash flow to the parent include, for example, bank and nonbank dividends, loan repayments, management and service fees, tax benefits, interest income, and liquidation of assets; cash needs would include interest and operating expenses, debt retirement, and preferred and common stock dividends. The analysis should also take into account the capacity of the parent company to

safely obtain liquidity from its subsidiaries by, for example, the prudent upstreaming of additional subsidiary dividends.

Factors which should be incorporated in the analysis of the parent company include—

1. volume and composition of parent-company debt, and cash-flow needs deriving therefrom;
2. comparison of the maturities of parent-company borrowings with the maturities of the investments which they fund;
3. quality of credits to nonaffiliated companies;
4. ability to readily convert assets to cash without incurring serious loss or adversely affecting the banking subsidiaries;
5. ability of management to plan for liquidity and cash-flow needs and respond to changing conditions in the markets for short-term funds;
6. ability of the company to obtain long- and short-term funds on reasonable terms, and the existence of firm backup lines of credit;
7. reasonableness of any bank management or service fees paid to the parent;
8. demonstrated performance in meeting past and current servicing requirements; and
9. ability of parent management to supervise and exercise overall control over subsidiary and parent operations to ensure prudent operation, sound asset administration, and compliance with established holding company policies and relevant laws and regulations.

Also of importance, but treated elsewhere, are the use of parent debt to fund equity investments in subsidiaries, the adequacy of the company's capital and capital plans, and the strength of corporate earnings.

The shell company would be appraised in a manner similar to that outlined above. Cash flow to service parent-company debt would be the major aspect of the analysis, with attention focused on its effects on the subsidiary bank's capital position. In addition, the amount of parent-company debt should be compared to the parent's proportionate interest in the subsidiary bank's equity capital. This serves as a good estimate of the company's ability to carry existing debt or to borrow additional funds should an unexpected need arise.

A parent company rating of 1 indicates that the holding company can readily generate cash flow which is more than adequate to service its debt obligations and other cash-flow needs and provide for the smooth rollover of debt without adverse effect on its subsidiaries. The rating also reflects good management and the absence of significant asset problems. A 2 rating, while reflecting a fundamentally sound situation, indicates a possible trend toward tighter liquidity due to lower earnings, asset quality, or other relevant operating indices. A rating of 3 represents a decidedly tight, but still manageable, cash-flow situation. The company will likely have little or no liquidity in its asset portfolio and/or be overly dependent on potentially harmful dividends and fees from its subsidiaries. Weak earnings might also be expected to complicate such a situation. The 3 rating would reflect increasing difficulty for the parent company in obtaining short-term funds on favorable terms. A rating of 4 indicates serious cash-flow problems caused or exacerbated by severe asset deterioration or poor or no corporate earnings. Companies so rated may be seriously draining funds from bank subsidiaries to service cash-flow needs and may be completely unable to serve as a source of funds or financial strength to their subsidiaries. A rating of 5 may represent an inability to enter money markets. Moreover, the problems represented by a rating of 5 would reflect an imminent danger of default or insolvency of the parent company.

4070.0.7 EARNINGS—CONSOLIDATED

The rating of earnings is based on the assessment of fully consolidated profitability. This approach is appropriate since consolidated earnings serve as a source of financial strength and capital growth for the entire organization.

Profitability has two dimensions, quantity and quality, both of which must be incorporated in the evaluation of earnings. Quantity refers to the absolute level of net income and its adequacy in relation to the considerations listed below. The appraisal of quality is an attempt to determine the strength of operating earnings (i.e., the ability to generate ongoing revenues and hold down expenses), and the degree to which earnings reflect the impact of unusually large securities gains or losses, unusual tax items (i.e., credits, carryforwards, etc.), or other large, nonrecurring, extraordinary gains or losses. Quality of earnings also refers to the effect on net income of adequately providing additions to the loan-loss reserve to properly recognize the impact of poor, overstated, or loss assets carried on the balance sheet. Other things being equal, consolidated net income that relies unduly on unusually large, nonrecurring gains or that fails to reflect adequate loan-loss provisions is of lower quality

than net income of equal magnitude that reflects strong operations and adequate loss provisions. On the other hand, the concept of quality ''works both ways.'' While care must be taken to avoid attempting to predict the future, net income that otherwise appears somewhat low may be of high quality and, consequently, suggests stronger future net income. This would especially be the case if current earnings reflected a level of charge-offs that was not expected to recur, given the relatively high quality of the company's assets.

Generally, consolidated earnings since the prior inspection will be rated with emphasis given to the most recent year's performance. In light of the above discussion, earnings will be rated with respect to the following considerations:

1. the return on consolidated assets, historical earnings trends, and peer-group comparisons
2. the quality of earnings as reflected by (a) extent of reliance on nonrecurring gains or losses or unusual tax effects, and (b) the sufficiency of loss provisions in view of the condition of the asset portfolio and the adequacy of the loan-loss reserves
3. the ability to adequately cover charge-offs, maintain public confidence, and provide for the safe, ongoing operation of the company
4. the ability of management to plan and devise realistic earnings projections in light of the risk structure and quality of assets
5. the outlook for earnings as implied by the current risk structure and quality of assets
6. the ability of earnings to provide for the growth of capital in light of recent and planned asset growth

Inclusion of no. 6 above is not meant to suggest that the level or adequacy of current capital determines the rating for earnings; capital per se is treated elsewhere. It simply recognizes that retained earnings is a primary source of capital. If a company opts for rapid growth, its earnings must enable it to raise the necessary capital either through retention or by permitting ease of entry into the capital markets. While this notion must be kept in mind in evaluating a company's profitability, it is quite possible for a company to simultaneously have low capital and good earnings or vice versa.

Earnings rated 1 are sufficient to make full provision for the absorption of losses and accretion of capital when due consideration is given to asset quality and bank holding company growth. Generally, holding companies so rated will have earnings well above peer-group averages. A company whose earnings are relatively static or even moving downward may receive a 2 rating, provided its level of earnings is adequate in view of the considerations discussed above. Normally, companies so rated will have earnings that are in line with or slightly above peer-group norms. A 3 rating should be accorded earnings that are not fully adequate to make sufficient provisions for the absorption of losses and the accretion of capital in relation to company growth. The earnings pictures of such companies may be further clouded by static or inconsistent earnings trends, chronically insufficient earnings, or less than satisfactory asset quality. Earnings of such companies are generally below peer-group averages. Earnings rated 4, while generally positive, are clearly not adequate to make full provision for losses and the necessary accretion of capital. Companies with earnings rated 4 may be characterized by erratic fluctuations in net income, poor earnings (and the likelihood of the development of a further downward trend), intermittent losses, chronically depressed earnings, or a substantial drop from the previous year. Earnings of such companies are ordinarily substantially below peer-group averages. Bank holding companies with earnings accorded a 5 rating should be experiencing losses or reflecting a level of earnings that is worse than that defined in rating 4 above. Such losses, if not reversed, could represent a distinct threat to the holding company's solvency through the erosion of capital.

4070.0.8 CAPITAL ADEQUACY—CONSOLIDATED

Capital is to be evaluated with regard to the volume and risk of the operations of the consolidated corporation. Emphasis on capital from the standpoint of the consolidated entity is appropriate since holding company management exercises some discretion with respect to the allocation of capital resources within the corporation. Thus, it is the holding company's capital on a consolidated basis that must serve as the ultimate source of support and strength to the entire corporation.

To be considered adequate, holding company capital must (1) support the volume and risk characteristics of all parent and subsidiary activities; (2) provide a sufficient cushion to absorb unanticipated losses arising from holding company and subsidiary activities; (3) support

the level and composition of corporate and subsidiary borrowing; and (4) serve as a source of strength by providing an adequate base for the growth of risk assets and permitting entry into the capital markets as the need arises. An essential step in the analysis of capital is the assessment of the risk characteristics and capital requirements deriving from the lending activities and operations of the parent and each of the operating subsidiaries.

The analysis of capital should incorporate the following considerations:

1. the relationship of consolidated capital to risk-weighted assets as reflected in (a) the ratio of tier 1 capital to total risk-weighted assets, and (b) the ratio of total capital to risk-weighted assets
2. the capital requirements that derive from the asset quality and risk associated with each holding company activity
3. the relationship of consolidated debt to tier 1 capital
4. the extent of reliance on long-term debt in the capital structure
5. the extent of the use of debt at the parent level to fund capital investments in subsidiaries
6. the trends of indices of capital adequacy and peer-group ratio comparisons
7. the management's ability to devise adequate capital plans and retention policies in light of any capital deficiency and/or planned expansion of risk assets
8. the capacity to enter capital markets or tap other sources of long-term debt and equity
9. the extent of any balance-sheet concentration in any category or related categories of intangible assets, particularly those in excess of the 25 percent threshold, including the reasonableness of the amortization periods of those assets
10. the relationship of high or inordinate off-balance-sheet risk exposure to tier 1 capital
11. the nature and amount of nonbanking activities in relationship to tier 1 and total capital levels

4070.0.8.1 Rating Consolidated Capital

The capital adequacy guidelines discussed in sections 4060.3 and 4060.4 are to be used in the inspection of bank holding companies. Holding company inspections should contain information on the principal subsidiary banks' capital positions. Inspection reports should contain critical comments on the capital positions of individual subsidiary banks supervised by other agencies only if the criticisms are consistent with the other agencies' positions as described in examination reports, or if they have first been discussed with the primary supervisor of the bank. Inspection reports should address any instances of noncompliance with capital commitments made in connection with the Federal Reserve's approval of bank holding company applications.

While the ratio guidelines are to be applied to both the bank and its holding company, it is the consolidated entity whose financial condition and strength will ultimately determine the condition of the banking organization. It is recognized that, to some extent, strong consolidated holding company capital positions may offset minor deficiencies in the bank subsidiaries. However, bank capital positions, particularly those that reflect double leveraging, generally do not alleviate consolidated holding company capital deficiencies.

4070.0.9 DISCLOSURE OF NUMERIC BOPEC COMPOSITE AND COMPONENT INSPECTION RATINGS

It is a long-standing policy of the Federal Reserve to discuss fully and clearly in examination and inspection reports, and in meetings with senior management and boards of directors, supervisory issues, problems, or concerns relating to the banking organizations under the System's supervision. Beginning on December 16, 1988, the Board authorized examiners to disclose to the senior officials and boards of directors of inspected bank holding companies the composite numeric rating assigned in an inspection as part of the inspection report process (see SR-88-37). Generally, the Federal Reserve has also provided senior management and directors with the word descriptions that consist of a single word corresponding to the numeric component ratings assigned.

In an effort to further strengthen communication with supervised banking organizations, beginning on January 1, 1997, the Federal Reserve will also provide the numeric and the assigned alphabetic component ratings under various supervisory rating systems[1] to senior manage-

1. The disclosure of the composite and supporting component rating applies to the following rating systems:
- CAMELS (state member banks)
- BOPEC (bank holding companies)

continued

ment and directors (see SR-96-26 and section 5010.4). Such disclosure includes the alphabetic component ratings assigned to management under the BOPEC rating system. Building on existing practice, this step is intended to better focus management's attention on possible areas of weakness and the need for timely corrective actions.

The disclosure of the rating and its components should be made in the Examiner's Comments and Matters Requiring Special Board Attention, core page 1 of inspection reports; in the summary reports prepared for boards of directors of inspected institutions; and in meetings with senior management and directors. In conjunction with disclosing the ratings and their components, examiners and/or supervisory officials should clearly explain their meaning.

In the context of the exit meeting, the examiner should discuss key overall inspection findings, including preliminary composite and component numeric ratings. Examiner-assigned ratings are subject to a review by Reserve Bank supervisory officials, and final ratings are to be included in the inspection report. *In disclosing composite and component ratings, the examiner-in-charge should remind management that the ratings assigned are a part of the findings of the inspection and are privileged and confidential under applicable law.* If composite and component ratings are changed between inspections as a result of off-site analysis, the board of directors and management should be informed of the change. Ratings should not be disclosed to the bank holding company's directors and management until preliminary approval has been received from the appropriate senior Reserve Bank supervisory officials.

- CAMEO (Edge and agreement corporations and overseas subsidiaries of U.S. banks)
- ROCA (U.S. branches and agencies of foreign banking organizations)
- the Uniform Interagency Trust Rating System
- the Uniform Interagency Rating System for Data Processing Operations

The Federal Reserve places significant supervisory emphasis on the importance of sound risk-management processes and strong internal controls when evaluating the activities of banking organizations it supervises. Properly managing risks is always critical to the conduct of safe and sound banking activities, and it is even more important as new technologies, product innovation, and the size and speed of financial transactions change the nature of banking markets.

A bank holding company's failure to establish a management structure that adequately identifies, measures, monitors, and controls the risks involved in its various products and lines of business has long been considered unsafe and unsound conduct. Accordingly, while a bank holding company's financial performance is an important indicator of the adequacy of management, it is essential that examiners give significant weight to the quality of risk-management practices and internal controls when they evaluate the management and overall financial condition of banking organizations.

Consistent with the greater supervisory emphasis given to risk management in Federal Reserve examination and supervisory policy statements, System examiners are to assign a formal supervisory rating to the adequacy of a bank holding company's risk-management processes, including its internal controls. This step is a natural extension of current procedures that incorporate an assessment of risk management and internal controls during each on-site, full-scope inspection. The specific rating of risk management and internal controls should be given significant weight when evaluating management under the bank holding company (BOPEC) rating system. Like the components of this system, the risk-management rating should be based on a five-point numerical scale.

This rating of the risk-management process is designed to bring together and summarize much of the analysis of and many of the findings about a bank holding company's process for managing and controlling risks, which are an important part of the examiner's review of these individual areas. The formal rating is intended to highlight and incorporate both the quantitative and qualitative aspects of an examiner's review of an organization's overall process for identifying, measuring, monitoring, and controlling risk and to facilitate appropriate follow-up action.

The overall profitability, asset quality, and capital adequacy of a bank or bank holding company should continue to influence the examiner's assessment of management, but these indicators can to some extent be affected, either favorably or adversely, by factors outside management's control. For this reason, the specific evaluation of the risk-management process should be a primary factor when rating management, especially in the case of larger banking organizations whose activities and structures require more formal and extensive procedures.

Examiners should apply this guidance flexibly to appropriately reflect the banking organization's circumstances and the nature, scope, and complexity of its operations. Risk-management ratings should be assigned to all bank holding companies, regardless of their size.

Examiners should discuss in a clear and straightforward manner in the appropriate open sections of the inspection report the nature and severity of any problems or deficiencies found and the steps required to correct them, particularly if the risk-management rating is less than satisfactory. Serious lapses or deficiencies in internal controls, including inadequate separation of duties, can constitute an unsafe and unsound practice and possibly lead to significant losses or otherwise compromise the financial integrity of the organization. If appropriate, the bank holding company's directors and officers should be advised that the Federal Reserve will initiate supervisory actions if its failure to separate critical operational duties creates the potential for serious losses or if material deficiencies or situations that threaten the safe and sound conduct of its activities are not adequately addressed in a timely manner. Such supervisory actions may include formal enforcement actions against the bank holding company, its responsible officers and directors, or both and would require the immediate implementation of all necessary corrective measures.

4070.1.1 ELEMENTS OF RISK MANAGEMENT

When rating the quality of risk management at bank holding companies as part of the evaluation of the overall quality of management, examiners should place primary consideration on findings relating to the following elements of a sound risk-management system:

- active board and senior management oversight
- adequate policies, procedures, and limits
- adequate risk measurement, monitoring, and management information systems
- comprehensive internal controls

Examiners should recognize that the considerations specified in SR-95-51 are intended only to assist in the evaluation of risk-management practices. *They are not a checklist of requirements for an individual organization*. Moreover, while all bank holding companies should be able to assess the major risks of the consolidated organization, examiners should expect parent companies that centrally manage the operations and functions of their subsidiary banks to have more comprehensive, detailed, and developed risk-management systems than companies that delegate the management of risks to relatively autonomous banking subsidiaries.

4070.1.1.1 Active Board and Senior Management Oversight

In assessing the quality of the oversight by boards of directors and senior management, examiners should consider whether the bank holding company follows policies and practices such as those described below:

- The board and senior management have identified and have a clear understanding and working knowledge of the types of risks inherent in the bank holding company's activities, and they make appropriate efforts to remain informed about these risks as financial markets, risk-management practices, and the bank holding company's activities evolve.
- The board has reviewed and approved appropriate policies to limit risks inherent in the bank holding company's lending, investing, trading, trust, fiduciary, and other significant activities or products.
- The board and management are sufficiently familiar with and are using adequate record-keeping and reporting systems to measure and monitor the major sources of risk to the organization.
- The board periodically (1) reviews and approves risk exposure limits to conform with any changes in the bank holding company's strategies, (2) addresses new products, and (3) reacts to changes in market conditions.
- Management ensures that its lines of business are managed and staffed by personnel with knowledge, experience, and expertise consistent with the nature and scope of the bank holding company's activities.
- Management ensures that the depth of staff resources is sufficient to operate and soundly manage the bank holding company's activities and that its employees have the integrity, ethical values, and competence that are consistent with a prudent management philosophy and operating style.
- All levels of management adequately supervise the day-to-day activities of officers and employees, including management supervision of senior officers or heads of business lines.
- Management is able to respond to risks that may arise from changes in the competitive environment or from innovations in markets in which the organization is active.
- Before embarking on new activities or introducing new products, management identifies and reviews all risks associated with the activity or product and ensures that the infrastructure and internal controls necessary to manage the related risks are in place.

4070.1.1.2 Adequate Policies, Procedures, and Limits

A bank holding company's board of directors and senior management should tailor their risk-management policies and procedures to the types of risks that arise from the organization's activities. The following guidelines should assist examiners in evaluating the adequacy of a bank holding company's policies, procedures, and limits:

- The bank holding company's policies, procedures, and limits provide for adequate identification, measurement, monitoring, and control of the risks posed by its lending, investing, trading, trust, fiduciary, and other significant activities.
- The policies, procedures, and limits are consistent with management's experience level, the organization's stated goals and objectives, and its overall financial strength.
- Policies clearly delineate accountability and lines of authority across the organization's activities.
- Policies provide for the review of new activities of the organization to ensure that the infrastructures necessary to identify, monitor,

and control risks associated with an activity are in place before the activity is initiated.

4070.1.1.3 Adequate Risk Monitoring and Management Information Systems

Effective risk monitoring requires banking organizations to identify and measure all material risk exposures. Consequently, risk-monitoring activities must be supported by information systems that provide senior managers and directors with timely reports on the financial condition, operating performance, and the risk exposure of the consolidated organization, as well as with regular and sufficiently detailed reports for line managers engaged in the day-to-day management of the organization's activities.

In assessing the adequacy of a bank holding company's measurement and monitoring of risk and its management reports and information systems, examiners should consider whether the following conditions exist:

- The bank holding company's risk-monitoring practices and reports address all of its material risks.
- Key assumptions, data sources, and procedures used in measuring and monitoring risk are appropriate and adequately documented and tested for reliability on an ongoing basis.
- Reports and other forms of communication are consistent with the bank holding company's activities; are structured to monitor exposures and compliance with established limits, goals, or objectives; and, as appropriate, compare actual versus expected performance.
- Reports to management or the directors are accurate and timely and contain sufficient information for decision makers to identify any adverse trends and to evaluate adequately the level of risk the bank holding company faces.

4070.1.1.4 Adequate Internal Controls

A bank holding company's internal control structure is critical to its safe and sound functioning generally and to its risk-management system, in particular. Establishing and maintaining an effective system of controls, including the enforcement of official lines of authority and the appropriate separation of duties—such as trading, custodial, and back-office—is one of management's more important responsibilities.

Appropriate segregation of duties is a fundamental and essential element of a sound risk-management and internal control system. Failure to implement and maintain an adequate separation of duties can constitute an unsafe and unsound practice and possibly lead to serious losses or otherwise compromise the financial integrity of the bank holding company. Serious lapses or deficiencies in internal controls, including inadequate segregation of duties, may warrant supervisory action, including formal enforcement action.

When properly structured, a system of internal controls promotes effective operations and reliable financial and regulatory reporting; safeguards assets; and helps to ensure compliance with relevant laws, regulations, and bank holding company policies. Ideally, internal controls are tested by an independent internal auditor who reports directly to either the bank holding company's board of directors or its designated committee, which is typically the audit committee. Personnel who perform these reviews should generally be independent of the function they are assigned to review. Given the importance of appropriate internal controls to banking organizations of all sizes and risk profiles, the results of audits or reviews, whether conducted by an internal auditor or other personnel, should be adequately documented, as should management's responses to them. In addition, communication channels should exist that allow negative or sensitive findings to be reported directly to the board of directors or the relevant board committee.

In evaluating the adequacy of a bank holding company's internal controls and audit procedures, examiners should consider whether the following conditions are met:

- The system of internal controls is appropriate to the type and level of risks posed by the nature and scope of the organization's activities.
- The bank holding company's organizational structure establishes clear lines of authority and responsibility for monitoring adherence to policies, procedures, and limits.
- Reporting lines provide sufficient independence of the control areas from the business lines, and they provide adequate separation of duties throughout the organization, such as those relating to trading, custodial, and back-office activities.
- Official organizational structures reflect actual operating practices.
- Financial, operational, and regulatory reports are reliable, accurate, and timely. When appli-

cable, exceptions are noted and promptly investigated.
- Adequate procedures exist for ensuring compliance with applicable laws and regulations.
- Internal audit or other control review practices provide for independence and objectivity.
- Internal controls and information systems are adequately tested and reviewed; the coverage, procedures, findings, and responses to audits and review tests are adequately documented; identified material weaknesses are given appropriate and timely high-level attention; and management's actions to address material weaknesses are objectively verified and reviewed.
- The audit committee or board of directors reviews the effectiveness of internal audits and other control review activities regularly.

4070.1.2 RATING DEFINITIONS

The rating for risk management is based on a scale of one through five in ascending order of supervisory concern. Examiners should assign this rating to reflect their findings in all four of the elements of sound risk management described above. The risk-management rating should be reflected in the overall ''Management'' rating of the bank holding company and should be consistent with the following criteria:

Rating 1 (Strong). A rating of 1 indicates that management effectively identifies and controls all major types of risk posed by the bank holding company's activities, including those from new products and changing market conditions. The board and management are active participants in managing risk and ensure that appropriate policies and limits exist, and the board understands, reviews, and approves them. Policies and limits are supported by risk-monitoring procedures, reports, and management information systems that provide management and the board with the necessary information and analysis to make timely and appropriate responses to changing conditions.

Internal controls and audit procedures are sufficiently comprehensive and appropriate to the size and activities of the bank holding company. There are few noted exceptions to the organization's established policies and procedures, and none is material. Management effectively and accurately monitors the condition of the organization consistent with standards of safety and soundness and in accordance with internal and supervisory policies and practices. Risk management is considered fully effective to identify, monitor, and control risks to the bank holding company.

Rating 2 (Satisfactory). A rating of 2 indicates that the bank holding company's management of risk is largely effective but lacking to some modest degree. It reflects a responsiveness and ability to cope successfully with existing and foreseeable exposures that may arise in carrying out the organization's business plan. While the bank holding company may have some minor risk-management weaknesses, these problems have been recognized and are being addressed. Overall, board and senior management oversight, policies and limits, risk-monitoring procedures, reports, and management information systems are considered satisfactory and effective in maintaining a safe and sound bank holding company. Generally, risks are being controlled in a manner that does not require additional or more than normal supervisory attention.

Internal controls may display modest weaknesses or deficiencies, but they are correctable in the normal course of business. The examiner may have recommendations for improvement, but the weaknesses noted should not have a significant effect on the safety and soundness of the organization.

Rating 3 (Fair). A rating of 3 signifies that risk-management practices are lacking in some important ways and, therefore, are a cause for more than normal supervisory attention. One or more of the four elements of sound risk management is considered fair and has precluded the organization from fully addressing a significant risk to its operations. Certain risk-management practices are in need of improvement to ensure that management and the board are able to identify, monitor, and adequately control all significant risks to the organization. Weaknesses may include continued control exceptions or failures to adhere to written policies and procedures, which could have adverse effects on the organization.

The internal control system may be lacking in some important respects, particularly as indicated by continued control exceptions or by the failure to adhere to written policies and procedures. The risks associated with the internal control system could have adverse effects on the safety and soundness of the bank holding

company if corrective actions are not taken by management.

Rating 4 (Marginal). A rating of 4 represents marginal risk-management practices that generally fail to identify, monitor, and control significant risk exposures in many material respects. Generally, such a situation reflects a lack of adequate guidance and supervision by management and the board. One or more of the four elements of sound risk management is considered marginal and requires immediate and concerted corrective action by the board and management. A number of significant risks to the organization have not been adequately addressed, and the risk-management deficiencies warrant a high degree of supervisory attention.

The bank holding company may have serious identified weaknesses, such as an inadequate separation of duties, that require substantial improvement in its internal control or accounting procedures or in its ability to adhere to supervisory standards or requirements. Unless properly addressed, these conditions may result in unreliable financial records or reports or operating losses that could seriously affect the safety and soundness of the bank holding company.

Rating 5 (Unsatisfactory). A rating of 5 indicates a critical absence of effective risk-management practices to identify, monitor, or control significant risk exposures. One or more of the four elements of sound risk management is considered wholly deficient, and management and the board have not demonstrated the capability to address deficiencies.

Internal controls may be sufficiently weak as to seriously jeopardize the continued viability of the bank holding company. If such weaknesses are not already evident, there is an immediate concern as to the reliability of accounting records and regulatory reports and about potential losses that could result if corrective measures are not taken immediately. Deficiencies in the bank holding company's risk-management procedures and internal controls require immediate and close supervisory attention.

4070.1.3 REPORTING CONCLUSIONS

For bank holding companies, the separate numerical rating for risk management and the rationale for the rating assigned should be included as "Risk-Management Rating: (numerical rating)" and discussed on confidential page B, Condition of Bank Holding Company, of the bank holding company inspection report, and should also be reflected in the examiner's overall rating of management. Comments, conclusions, and criticisms relating to a bank holding company's risk-management process should be brought to the attention of management and included on the Policies and Supervision page[1] of the bank holding company inspection report, as well as on Core Page 1, Examiner's Comments and Matters Requiring Special Board Attention, if considered appropriate and particularly if the rating is less than satisfactory.

In inspection reports and transmittal letters to boards of directors of bank holding companies, reference should be made specifically to the types and nature of corrective actions that bank holding companies need to take to address noted risk-management and internal control deficiencies. When appropriate, bank holding companies should also be advised that the Federal Reserve will initiate supervisory actions if the failure to separate critical operational duties creates the potential for serious losses or if material deficiencies or situations that threaten the safe and sound conduct of their activities are not adequately addressed in a timely manner. Such supervisory actions may include formal enforcement actions against the bank holding company (or a state member bank), its responsible officers and directors, or both and would require the immediate implementation of all necessary corrective measures.

1. If a problem area is cited within the Core Section, the respective supporting report pages (the Policies and Supervision page) are to be included in the report to support the critical comments. See section 5010.1.3.

Supervisory ratings should be revised whenever there is strong evidence that the financial condition or risk profile of an institution has significantly changed.[1] In a risk-focused and continuous-supervision environment, supervisory ratings should be viewed as a continuum, rather than as a point-in-time assessment of an institution's financial condition.[2] It is important that supervisory ratings reflect a current assessment of an institution's financial condition and risk profile. The ratings can affect risk-based deposit insurance premiums; statutory and regulatory requirements, including applications and the prompt-corrective-action provisions of the Federal Deposit Insurance Act; and supervisory reporting and inspection/examination requirements, as well as other factors. While supervisory ratings are most frequently revised as a result of on-site supervisory activities, other sources of information reviewed off-site may also indicate the need for a rating change.[3] See SR-99-17.

In addition, when a component of one of the supervisory rating systems is changed, the Reserve Bank must also reaffirm or revise the other component ratings and the composite rating, based upon available information at that time. The factors contributing to a change in the rating of a selected component can affect one or more of the other components in the rating system, as well as the composite rating. Accordingly, if there is a compelling reason to change a selected component rating, all of the other components in the supervisory rating system must be either reaffirmed or revised. As applicable for bank holding companies and state member banks, the risk-management rating must also be reaffirmed or revised when a CAMELS or BOPEC rating is changed.[4]

Any change to a component or composite rating and the rationale for that change must be communicated in writing via a letter or report to the board of directors of the affected institution (or to the senior U.S. management official in the case of a U.S. branch, agency, office, or nonbank subsidiary of a foreign bank) and to the appropriate state and federal supervisory agencies.

1. SR-99-17 supersedes SR-92-31, which suspended the practice of revising CAMELS ratings for state member banks between examinations.

2. The procedures in SR-99-17 pertain to supervisory rating systems for bank holding companies (BOPEC); state member banks (CAMELS); U.S. branches and agencies of foreign banking organizations (ROCA); and Edge and agreement corporations, overseas subsidiaries of U.S. banks, and U.S. nonbank subsidiaries of foreign banking organizations (CAMEO).

3. For example, a significant change in financial condition may be evident from some combination of reports of examination conducted by other agencies, meetings or other communication with management of the institution, published financial reports or press releases, status reports submitted by the institution as required by an enforcement action, and information generated by ongoing surveillance activities.

4. Pursuant to the guidelines set forth in SR-97-27, the assignment of a separate risk-management rating is not required for small shell bank holding companies.

Under the Systemwide Bank Holding Company Surveillance Program, bank holding company financial data are monitored by computer-generated screens on an ongoing basis. Information generated through the surveillance process is to be used to monitor the financial condition of BHCs between inspections, assist in setting inspection schedules, and allocate supervisory or inspection resources toward institutions with declining financial conditions.

The Systemwide Surveillance Program consists of three components: The first phase consists of computer screening of BHC financial data, which involves generating and reviewing an exception list of organizations meeting the exception criteria (these BHCs are referred to as having ''failed the screen''). During the second phase, an analysis is prepared that discusses the factors or reasons why the BHCs appeared on the exception list. The analysis is based on data summarized in the BHC Performance Report (BHCPR), the off-site SEER (System to Estimate Examination Ratings) rating and the on-site CAMELS rating, supplemental investment and other screens, as well as on other relevant financial data. The third phase focuses on developing a suitable supervisory response, corrective action, and follow-up by System staff to address problems first identified through the surveillance process.

The *computer screen*, generated at the Board, identifies BHCs that have over $150 million in consolidated assets and those multibank holding companies that have less than $150 million in consolidated assets (and that may have financial weaknesses or deficiencies). The *analytical* effort of Reserve Bank analysts and examiners is designed to spot trends and changes in financial condition and to determine if companies identified by the screening effort require further in-depth review. The System *corrective action and follow-up* ensures that identified problems are monitored until they can be corrected or resolved.

The BHC surveillance program is designed to meet the following objectives:

- To monitor BHC performance using the BHCPR.
- To incorporate SEER and CAMELS ratings into an off-site monitoring program. The SEER rating model identifies, based on the most recent call report data, banks that exhibit financial characteristics of those in lower-rated categories.[1] Because the condition of a consolidated holding company is typically highly correlated with the condition of its bank subsidiaries, the BHC surveillance program makes use of the off-site SEER ratings and on-site CAMELS ratings of bank subsidiaries in identifying deteriorating holding companies.
- To achieve a BHC program that is sensitive to changes in the condition of the banking industry. The financial criteria, as discussed below, identify outliers based on either a poor relative percentile ranking or absolute levels of key financial ratios that meet minimum benchmarks.
- To incorporate supplemental screens into the BHC surveillance process. A supplemental investment activities screen identifies holding companies with high levels of unrealized securities depreciation relative to tier 1 capital. Additional supplemental criteria may include BHCs identified through growth and parent company screens, as well as screens based on the FR Y-11 nonbank reporting series.
- To provide monitoring tools for BHCs with assets below $150 million. By comparing bank subsidiary CAMELS/SEER rating results to BOPEC ratings for all BHCs, the BHC program provides a mechanism to monitor the thousands of top-tier holding companies with assets below $150 million. While written analyses are not required for these companies, this common surveillance tool assists Reserve Bank personnel in prioritizing which of these companies merit increased supervisory focus (discussed in more detail below).
- To enhance and maintain quarterly communication with Reserve Bank surveillance staff. The Board's Surveillance Section sends a quarterly letter to all Reserve Banks to inform them of the most recent quarter's surveillance results. A corresponding Reserve Bank quarterly letter to the Board provides Reserve Bank staff with an opportunity to report on BHCs not identified in the Board screening process, but whose condition has deteriorated significantly since the last inspection.

1. The SEER methodology is described in detail in ''FIMS: A New Monitoring System for Banking Institutions,'' January 1995 *Federal Reserve Bulletin* 1–15. The acronym FIMS was substituted in the article for the acronym SEER. However, both acronyms describe the same system.

4080.0.1 EXCEPTION LIST

BHC surveillance is conducted quarterly for all banking organizations for the reporting periods ending on the last days of March, June, September, and December. Board staff initiate the surveillance process by subjecting all BHCs, regardless of size or BOPEC rating, to the screens. BHCs that fail the screens and are top-tier holding companies that (1) file the FR Y-9C report; (2) have consolidated assets of $150 million or more; (3) have a composite BOPEC rating of 1, 2, or 3; (4) have not been designated as an ''atypical'' BHC by the responsible Reserve Bank; and (5) are not part of the top 50 population are placed on the exception list.

The Board sends quarterly BHC exception lists to the surveillance staff at each Reserve Bank following the finalization of FR Y-9 data. Reserve Banks review the condition of the BHC, prepare a written analysis addressing factors that caused the BHC to be placed on the exception list, and submit written analyses of the BHCs on the list to the Board. The deadline for submission of written analyses is extended if the Reserve Bank determines that an on-site presence is warranted to satisfy the requirements of the written analysis.

Three surveillance screens are used to identify BHC exceptions as outlined below:

1. *Rating screen*. The rating screen provides a comparison between the bank component (''B'') in a BHC's BOPEC rating and the asset-weighted CAMELS and SEER ratings for the company's bank subsidiaries. It includes companies meeting the criteria below:

Bank Component (''B'') BOPEC Rating	*Weighted CAMELS Rating*	*or Weighted SEER Rating*
1	3 +	3 +
2	3 +	3 +
3	4 +	4 +

2. *Financial screen*. The financial screen uses three consolidated ratios from the BHCPR and identifies exceptions as bank holding companies that meet the cut-off criteria for at least *two* of these ratios. A company can qualify as an exception if it (1) meets the minimum *relative* criteria for two of the ratios, which indicates a BHC with a poor percentile ranking relative to its BHCPR peer group, or (2) meets the *absolute* criteria for two of the ratios. The latter indicates a BHC with a low level of earnings or capital or with a high level of nonperforming assets. Specific ratios are presented in the table on the following page.

3. *Investment activities screen*. The investment activities screen identifies BHCs whose ratio of total unrealized securities depreciation (after tax) to tier 1 capital is –15 percent or worse *and* whose leverage ratio, adjusted for total securities depreciation, is less than 5 percent.

A written analysis is prepared for investment activities exceptions when one or both of the following conditions apply: (1) the organization manages the investment process on a consolidated or global basis (that is, the parent company or lead bank formulates and possibly implements the investment strategy for the parent company and bank subsidiaries) or (2) the majority of the organization's bank subsidiary assets consists of state member bank assets.

If the written analysis conditions do not apply, Reserve Banks are requested to provide a brief summary of the primary regulator's findings and actions concerning the bank subsidiaries' investment activities. This summary is to ensure that the primary regulator is aware of potential concerns with subsidiary banks' investment activities, and it also ensures that the BHC is acting as a source of strength to these particular bank subsidiaries. In addition, a BHC investment activities analysis does not have to be prepared if the Reserve Bank is in the process of preparing or has provided (in one of the previous two quarters) an investment activities analysis for one of the bank holding company's state member bank subsidiaries.

4080.0.2 REVIEW OF BHC EXCEPTION LIST AND RESERVE BANK ANALYSIS

The exception list provides a record of BHCs that failed the screens and helps track Reserve Bank conclusions on the reasons why they failed the screens. In their review, Reserve Banks are specifically requested to prepare a written analy-

Cut-Off Criteria—BHCPR Financial Screen Ratios

	Last Fourth-Quarter Return on Average Assets	*Tier 1 Leverage Ratio*	*Nonperforming and 90+ Days Past-Due Ratio*
Peer-Ranking Criteria	Percentile of 5 or less	Percentile of 5 or less	Percentile of 95 or more
Ratio Level Criteria	0.5% or less	5.0% or less	5.0% or more

sis for all BHCs on the exception list. This Reserve Bank analysis is to include the following sections:

1. *Heading*, including BHC's name, location, total assets, BOPEC rating, and date of last inspection; lead bank's name, location, charter, total assets, CAMELS rating, and date of last examination; the reason for appearance on the exception list; and the Reserve Bank analyst's name. For investment activities exceptions, also include the ratio of total securities depreciation to tier 1 capital and the leverage ratio adjusted for total securities depreciation.

2. *Background*, including a summary of prior surveillance results. For investment activities exceptions, a brief summary of the investment process is included (that is, who formulates and approves the investment strategy and how it is implemented for the organization).

3. *Analysis* of current period's surveillance results, highlighting key changes in the BHC's condition during the most recent quarter and since the most recent inspection. In particular, this analysis explicitly discusses whether the factors identified as being responsible for the company's appearance on the exception list present any cause for supervisory concern. Any areas where the current period's surveillance results are believed to be misleading or inaccurate are detailed in this section. Additional guidance regarding the analysis section is provided below:

a. The analysis should note any acquisitions, mergers, or de novo activities responsible for the BHC's meeting the exception criteria.

b. For BHCs that meet the CAMELS rating exception criteria, the analysis should explicitly discuss the factors underlying the CAMELS rating as presented in the examination findings.

c. For BHCs that meet the SEER rating exception criteria, the analysis should explicitly discuss the factors responsible for the SEER results, as presented in SEER Schedule 1A.

d. For BHCs that meet the financial exception criteria, the analysis should explicitly discuss the ratios identified by the financial screen.

e. For BHCs that require a written analysis of investment activities, the discussion should include—

- the securities portfolio composition and maturity;
- the investment strategy;
- management's ability to understand and manage the risks inherent in the investment portfolio, including a discussion of risk limits (For example, are the limits appropriate and is the BHC in compliance with these limits?);
- the ability and intent to hold securities with unrealized losses and any contingency plans if the ability to hold these securities is tested;
- the susceptibility of the portfolio to further depreciation (quantify if possible);
- hedging strategies, if any;
- the liquidity position of the BHC, including a discussion of the structure of the funding base and concentration of funding sources; and
- the overall impact of securities depreciation on the financial condition of the BHC.

f. For BHCs that fail the investment activities screen but do not meet the conditions requiring a written analysis of investment activities, a brief summary of the primary regulator's findings and actions concerning the bank subsidiaries' investment activities should be provided.

4. *Conclusion*, summarizing the BHC's condition and the key factors supporting the analysis.

5. *Corrective action*, detailing corrective action taken by the BHC or Reserve Bank staff,

including supervisory follow-up actions resulting from the current period's surveillance results. If no further actions are to be taken or recommended, the reason for this decision is stated, as well as the date and scope of the next scheduled inspection.

6. *Sign-off.* The analysis report is signed by an officer in charge of bank holding company supervision, an officer in charge of bank holding company surveillance, and, if there are any investment activities exceptions, a capital markets coordinator. The signatures may just appear once on the cover letter accompanying the individual BHC analyses.

4080.0.3 CORRECTIVE ACTION AND FOLLOW-UP

Corrective action associated with newly identified problems must be initiated by the Reserve Bank as soon as possible. Follow-up action may include correspondence or meetings with the banking organization's management or an on-site inspection/examination. Problem situations are closely monitored by System surveillance and supervision staff until they have been resolved.

4080.0.4 ATYPICAL BHCs

No written analysis is required for BHCs that are designated ''atypical.'' Reserve Banks identify atypical BHCs annually. Atypical BHCs could include those whose parent equity in nonbank subsidiaries is one-third or more than their equity in bank subsidiaries, those that choose not to consolidate material nonbank subsidiaries, and those BHCs that are directly owned by banks. BHCs may also be considered atypical due to other characteristics determined at the Reserve Bank's discretion.

The atypical BHC list should (1) provide the name, location, and RSSD-ID of the company; (2) explain the reason why the BHC is considered atypical; and (3) indicate whether the company was included on the list during the prior year. BHCs coming off the prior year's atypical listing are similarly identified and discussed.

Reserve Banks should monitor atypical BHCs quarterly and provide a written analysis for an atypical company when deemed appropriate.

4080.0.5 ROLE IN INSPECTION PROCESS

In setting inspection schedules, companies identified as having weak or declining financial conditions would generally not qualify for an extension of the inspection cycle as discussed in section 5000.0 of this manual. These companies, therefore, would be inspected more frequently than companies without deficiencies.

A pre-inspection analysis, using the latest BHCPR and other relevant data, should be performed to help the examiner to focus the inspection on areas that may require supervisory attention. This analysis may uncover declining financial trends or may indicate financial positions recently taken by the BHC that could eventually lead to a problem situation.

The performance report covers consolidated and parent-only, current and historical financial information; ratios; and peer-group percentiles. This information can be used to analyze and spot trends with respect to parent or consolidated asset growth, earnings, capital, liquidity, cash flow and leverage, and reliance on subsidiary dividends. By reviewing performance reports, analysts and examiners can gain insights to weaknesses, as well as to their nature and severity. For example, parent leverage, cash-flow, and coverage ratios may indicate problems at the parent level, which could have implications for the bank's financial condition. Information on the parent's income from subsidiaries could indicate that nonbank subsidiaries of the holding company are experiencing financial difficulties. Financial information on the parent's dependence on bank and nonbank subsidiaries through dividends and management fees, for example, can give the examiner valuable insights on the effect the holding company may be having on the financial condition of the subsidiaries, particularly on the depository institutions. Analysis of profitability ratios, income and expense data, and loan-loss information can also be used to pinpoint areas for further review when the examiners arrive on-site.

Much of this analysis can be conducted before the on-site inspection, thus enabling the examiner to better allocate his or her time on-premises to those areas requiring on-site review. For example, initial evaluations of capital, earnings, liquidity, leverage, and cash flow can be accomplished using information from the performance reports before the examiner's arrival on-site. This early evaluation will allow the examiner to isolate areas requiring further on-site review and also to focus attention on other areas that require on-site inspection, such

as asset quality, nonbank activities, management, supervisory report accuracy, and legal compliance.

Screening results should also be reviewed to determine which screens, or combination of screens, the BHC failed and by what margin. If a particular company has been identified as an exception, analyses conducted by Reserve Bank analysts should be reviewed as well as information available from Board staff. Finally, follow-up material available from Reserve Bank and Board staff should be reviewed and, in some cases, consultation with surveillance staff may be appropriate. The goal of all these activities is to help the examiner in identifying areas to focus on during the inspection.

Apart from the consideration of the creditworthiness of individual borrowers, holding companies engaged in international activities are subject to elements of country risk. Country risk encompasses the entire spectrum of risks arising from the economic, social and political environments of a foreign country, and governmental policies structured to respond to these conditions which may have potentially favorable or adverse consequences for foreigners' debt and equity investments in that country. More specifically country risk focuses on a borrower's capacity to obtain the foreign exchange required to service his cross-currency debt. A borrower's debt service capacity may also be affected by the risks of political and social upheaval, nationalization and expropriation, governmental repudiation of external indebtedness, exchange controls and devaluation. Events such as these may materially affect the condition of investments and profitability of lending activities overseas and examiners must alert management to those risks that may be difficult for the holding company and its subsidiaries to absorb.

Uniform examination procedures and techniques for evaluating country risk exposures have been adopted by the three federal regulators with respect to domestic banks. Under these procedures, examiners segregate country risk factors from the evaluation of other lending risks, and deal with this category of lending risks in a separate section of examination reports. The procedures emphasize diversification of exposure to individual countries as the primary method of moderating country risk in international portfolios. The approach consists of three parts:

1. The measurement of exposure in each country where a business relationship exists;
2. The analysis of exposure in relation to the bank's capital resources and the economic and financial conditions of each country in which the bank has outstanding credits;
3. Evaluation of the risk management system used by the bank in relation to the size and nature of its foreign lending activities.

4090.0.1 REPORTING REQUIREMENTS

4090.0.1.1 Country Risk Exposure Report (FFIEC 009)

Banks and bank holding companies that own banks are required to file the Country Exposure Report (Form FFIEC 009, formerly Form FR 2036) when the bank or banks have a foreign branch, a foreign subsidiary, or an Edge Corporation and have on a consolidated basis total outstanding claims on residents of foreign countries that exceed $30 million. The report is to be filed on a quarterly basis within 45 days of the end of March, June, September and December.

The report measures lending to residents of foreign countries by U.S. banking organizations and is used to provide information on the distribution by country of foreign claims held by such banking organizations, to assess country risk for supervisory purposes, and to assist the Bank for International Settlements in compiling worldwide data on cross-border claims.

4090.0.1.2 Country Exposure Information Report (FFIEC 009a)

This report is a supplement to the Country Exposure Report (FFIEC 009). The purpose of the Country Exposure Information Report is to provide public disclosure of significant country exposures of U.S. banking institutions. It is submitted by every institution that submits the (FFIEC 009) report and that has exposures meeting the reporting requirements for FFIEC 009a.

4090.0.1.3 Report for U.S. Branches and Agencies of Foreign Banks (FFIEC 019)

This report is similar to the (FFIEC 009) report that is filed by U.S. Banks. The (FFIEC 019) report collects information, by country, on the direct claims, indirect claims, and total adjusted claims on foreign residents; information on claims on related non-U.S. offices that are included in total adjusted claims on the home country; and a breakdown of adjusted claims on unrelated foreign residents. The data is used by the supervisory agencies to monitor significant foreign country exposures of U.S. branches and agencies of foreign banks. They are also used to evaluate the financial condition of these branches and agencies.

The Country Exposure Report for U.S. Branches and Agencies of Foreign Banks (FFIEC 019) is collected quarterly from those branches

and agencies of foreign banks that have, as of the quarterly report date, more than $30 million in total direct claims on residents of foreign countries. The FFIEC 019 provides data on the foreign risk exposure of each reporting branch and agency.

Respondents to the FFIEC 019 must prepare the data as of the close of each calendar quarter and submit the forms to the appropriate Reserve Bank no later than 45 days following the report date. Data are due at the Board 60 days following the report date.